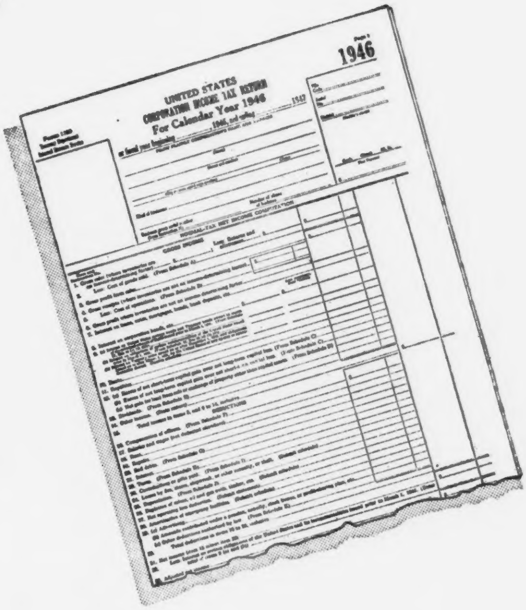
A Supplement to

DUN'S REVIEW


1946
UNITED STATES
CORPORATION INCOME TAX RETURN
For Calendar Year 1946

THE SHADOW OF "102" ON DIVIDEND POLICIES

with emphasis on the Immediate Tax Problems of Small Corporations

by EDWIN B. GEORGE
Economist, DUN & BRADSTREET, INC.
Associate Editor, DUN'S REVIEW

and

ROBERT J. LANDRY
Economist, DUN & BRADSTREET, INC.

DUN & BRADSTREET, INC.

NOTE

The table and explanatory paragraphs under point (b) on page 24 are misleading insofar as they convey the impression that Section 102 penalties are assessed only on that fraction of currently retained earnings as might be found "unreasonable". As the law reads, of course, the penalties apply to all retained earnings if any part thereof is found to be improper. Strict accuracy would require the following changes: In point 6, change "Item #5" to "Item #3"; in the text change 217,000 to 310,000, 72,333 to 103,333, 151,000 to 244,000; and cross out "improper" in the fourth line from the bottom, "improperly" in the seventh line from the top, and "unnecessary" in the eleventh line from the top.

THE SHADOW OF "102" ON DIVIDEND POLICIES

with emphasis on the Immediate Tax Problems of Small Corporations

by EDWIN B. GEORGE
Economist, DUN & BRADSTREET, INC.
Associate Editor, DUN'S REVIEW

and

ROBERT J. LANDRY
Economist, DUN & BRADSTREET, INC.

DUN & BRADSTREET, INC.

Contents

qu
hig
act
tax
bu
clo
ea
gr
(u
on
ho
the
im
po
Ar
wi
Ro
de
fo
th
fo
oc
pa
be

at
a
po
de
fe
ar
th
ta
it
ha
nu
A
bi
th
or
T

The Shadow of "102" on Dividend Policies

I. SECTION "102"

A. Nature and Purpose

The Bureau of Internal Revenue sometimes has the queerest jobs to do. First, the Congress decides to enact highly progressive personal income taxes. This over-activates the glands that make taxpayers dislike paying taxes, and causes them to seek ways to escape the burden. One possible avenue, particularly in the case of closely held and medium-sized corporations, is to allow earnings to accumulate in the corporate till. The Congress is incensed by this flouting of its will, and imposes (under Section 102 of the Revenue Code) a penalty tax on corporations that aid and abet their wayward stockholders by accumulating surpluses beyond the needs of the business. In strict logic, vast implications emerge immediately. Corporate surpluses constitute a respectable portion of America's resources and the future needs of American business is really an awesome concept. Faced with a general corporate uprising, the Bureau of Internal Revenue would have to take stock of America's future, determine the amount of capital that will have been found necessary to provide such a future, and nip off the remaining portions of accumulated surpluses or force them on reluctant stockholders. All this could well occur in the midst of a new economic era for which past standards of judgment are as dubious as they have been prior to previously distinct economic eras.

Actually, the Bureau of Internal Revenue does not attempt anything of the sort. Congress gave the Bureau a job to do, namely, to collect (as much) revenue (as possible) from designated people and institutions at designated rates. Congress had to pay heed to quite a few contradictory criteria in making these designations, and the adjustments sometimes needed to give same the appearance of a system are pure art. The Bureau takes the resulting medley and makes as much sense of it as it can. Historically, the number of penalties that have been imposed has not been very large, while the number of protests carried to court has been even smaller. A morbid imagination, however, is not required to find big meanings in some of the words of art used to hold the parts of the system together, and a little emphasis on them can cause considerable emotional disturbance. The makings of such a disturbance were supplied, in the opinion of some observers, by the Bureau's recent action in requesting corporate taxpayers to state on their tax returns whether or not they had distributed 70 per cent of their 1946 earnings, and if not, why not.

The setting of the issue can be most briefly indicated by quoting the most salient phraseology of the law followed by the exact language of the question. According to the law, the tax is to be levied on the "undistributed Section 102 net income of corporations . . . formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, ***through the medium*** of permitting earnings or profits to accumulate instead of being divided or distributed". Note the use of the word "through". The offense attacked is an attempt to avoid surtaxes, the method attacked is corporate accumulation. Prevention of the latter is not in itself an object under the law. An illustration of considerable importance to subsequent discussion is that large corporations with widely distributed shares are seldom challenged. So-called "close corporations" are the most vulnerable. The rate of tax is 27½ per cent of the first $100,000 of undistributed net income as defined, and 38½ per cent on any sum in excess of $100,000.

The question in the 1946 corporate income tax return read: "If the total of Line 1 of Schedule M, page 4, is less than 70 per cent of the earnings and profits of the taxable year, state reasons for retention of such earnings and profits." Line 1 of Schedule M read: "Total distributions to stockholders charged to earned surplus during the taxable year" and was to be broken down by cash, stock of the corporation, and other property. Although all three forms of disbursement were to make up the total to be reported, it is to be assumed that the Bureau's major interest lay in the kinds of dividends taxable to the stockholders. Under present laws, court decisions, and business practice, these would be principally cash.

Of late, prompted by this leading question, there has been a copious outpouring of literature on Section 102. The subject has been regarded as sufficiently serious to warrant a considerable expenditure of epigrams. Ex-

amples are "bit by bit the income-tax noose is being drawn more tightly"*, "is 102 monster or scarecrow"**, and "is Section 102 an animal 'with a bark considerably worse than its bite' or is it really a sleeping tiger?"*** The range of topics regarded as necessary to proper discussion has been wide. The long history of the section has been carefully reviewed, court cases exhumed, and the intentions and the administrative standards of the Bureau of Internal Revenue have been variously appraised. This article, however, is intent for the moment on certain economic aspects of the question which may in the long run have greater importance. In this viewpoint, the very necessity for such a question is more interesting than its immediate consequences. It will later be suggested that the excitement raised by it may appropriately lead the Congress to reconsider some general features of the tax system itself—eventually as to basic structure, immediately as it affects small corporations. The features to be suggested for such reconsideration have long been suspect and *L'Affaire* 102 presents as reasonable an occasion for it as any. While the initial descent of Section 102 is on corporations convicted of "unreasonable accumulations", the consequences spray thence over the entire economy. An effort will be made to show that the stakes are of substantial economic importance.

History, standards, and cases have been competently treated by lawyers and accountants in many technical discussions. The following references to the latter are therefore not to be regarded as technically adequate, but as necessary to clarification of the economic issues that they raise.

B. History

1. *Pre-World War II Experience*

The first surprise, in view of the attention that the experts have thought necessary to give the subject in 1946, is that the provision itself antedates World War I. It was first enacted in 1913, and has since been modified because of doubtful constitutionality in the original form and certain administrative stalemates. The original provision was amended in 1918, 1921, and 1934. Disregarding chronology three or four departures from the original law or its implementation have emerged.

(1) In 1938, the normal burden of proof on corporations was made more difficult. Now the Bureau no longer has to prove "intent". If a corporation holds on to more of its earnings than it "reasonably" needs, it is assumed to be avoiding personal surtaxes—unless it can very clearly prove the contrary. "Clear preponderances of evidence" replaces mere quantity or weight of evidence as the test of a successful defense.

(2) Under the original law the penalty tax was paid by shareholders on their respective shares of their corporation's retained earnings. Since 1921 (and in 1917), for reasons of constitutionality,† it has been payable by the corporation on "unreasonably" retained profits. Since 1934, it has been progressive. For some years a special surtax has been laid on personal holding companies. Current rates are 75 per cent on the first $2,000, and 85 per cent on anything in excess of that amount, superimposed on the regular corporate tax rates.

(3) From 1926 through 1937 the additional tax was not to apply if *all* the shareholders of a corporation included in their gross income their pro-rated shares, whether distributed or not, of the corporation's retained net income. For 1938 and thereafter this provision was replaced by the "consent dividends credit".

(4) Section 102 was not taken very seriously for many years, and court decisions have been available only since 1932. At no time has it been important as a revenue producer. While current business apprehension bespeaks a larger role for it now, even officials question whether as a practical matter the Bureau will get much further with it than it did before, "which was nowhere". As previously emphasized, the importance of the present flare-up, at least for the purpose of this article, is in its transverse illumination of seams in the tax structure.

2. *The World War II Holiday*

During the war the Bureau in effect declared a truce on Section 102 (although not with respect to the personal holding company tax) for three very good reasons:

(1) Retention of earnings was recognized to be necessary because of the uncertainties of reconversion. This was the principal consideration.

(2) Large profits were being taxed away because of the 85½ per cent tax on excesses.

(3) Renegotiation was taking 100 per cent of war profits regarded as excessive. (Although "excessive" was never well defined, the Renegotiation Boards took account of the efficiency of the taxpayer, the amount of risk incurred, the amount of money contributed by the Government, and other general criteria, all as set forth in the Act of 1944.) This treatment was limited to concerns in war work, although that included the great majority of manufacturing corporations. It was also applied, of course, to any other type of enterprise engaged in war work.

3. *The Bureau's Provocative Question*

The end of the war-time truce was, in the eyes of many taxpayers, rather flamboyantly signalled by the Bureau's open inquiry to all corporations as to whether they had

---

* J. S. Seidman, N. Y. Herald-Tribune, Dec. 1945.

** Editor's inquiry: *The Controller,* Dec. 1946.

*** A. A. Simon, "Corporate Surplus and Section 102 in the Postwar Period", *The Controller,* Dec. 1946. Mr. Simon drew his "bark vs. bite" billing from R. F. Barrett's article, "The Section 102 Penalty" in *Taxes, the Tax Magazine,* July 1946, in which the decision was awarded to "bark".

† Specifically, after the Supreme Court decision in *Eisner vs. Macomber* (1920) that stock dividends were not taxable income. The temporary shift in 1917 was made merely because of a Congressional doubt that shareholders could be taxed on the undistributed portions of their corporation's income.

distributed 70 per cent of their 1946 earnings. Those failing to do so were asked to explain. This is the inquiry that came to figure as the "monster or scarecrow", "bark or bite" question of the current tax season. Corporate as well as public finance had been knocked about in the course of this country's adjustment to a convulsing war, and loose material was available for almost any kind of theory as to why the Bureau had taken so unprecedented a step. The following will witness:

a. *Alarming theories*

The Treasury mourned the passing of the excess profits tax and the reduction in corporation taxes, and saw in old hobgoblin "102" a means of scaring out revenue to make good a part of the loss.

. . . . New Deal elements in the administration with stagnationist leanings, a resulting distrust of corporate savings, and to whom the old Undistributed Profits Tax was still a sacred cause, saw in "102" the best substitute available.

. . . . the Bureau of Internal Revenue was aiming to force prospective 1947 dividends into 1946 tax returns in anticipation of personal income tax reductions by Congress—or at least to prevent corporations from skimping 1946 dividend declarations to "carry" their stockholders into 1947.

. . . . or could it be this? The Government has been making large payments or allowances to corporations because of actual or potential war and reconversion losses. Many of these have been admittedly generous and have contributed handsomely to the surpluses that the Treasury is now eyeing. Does the Treasury yearn to recover some of its money? Is policy under the management of the subconscious? And would the courts respect that kind of motivation? Certainly not explicitly. On the other hand, this is one of those laws that depends heavily on "circumstances in each case", doubts have to be resolved against someone, and in such circumstances why not the taxpayer?

. . . . finally, the Government is fighting for money. Political parties seek credit with the public for cutting both taxes and expenditures, and for flashing the first surplus in the memory of middle-aged taxpayers. To do that every possible cent must be wrung from the taxes that cannot be dramatically cut, or that are cut by the Republication Congress against the wishes of the Administration. After all, the Treasury has an item in its budget reading: "additional assessment on back taxes". Section 102's contribution to it was extremely meager during the war. Now the wartime excuses are played out and those corporate surpluses are most inviting.

b. *The calm reaction*

This view at least has the merit of starting with a series of simple facts.

. . . . the Congress *did* assess high personal surtaxes, stockholders *do* try to avoid them by letting their corporations' earnings remain on the books, "102" *is* one of those case-by-case provisions lacking clear and simple standards and is therefore a messy administrative job, and the Bureau has to do *something* to administer it.

. . . . it is an interesting fact, and probably a significant one, that few of those feeling themselves to be personally injured by the tax show much rancor toward the Bureau. The feeling is rather one of frustration, or of annoyance at contradictions in the tax structure between which they are squeezed. As will later be shown, it might be because the parts of the tax system are poorly fitted, or because in their search for equity the lawmakers have overstepped the optimum line between public regulation and private initiative, or simply because in this completely new post-war setting the Bureau and the taxpayers are finding it difficult to make mental contact again.

c. *Possible Bureau views*

At any rate the Bureau professes as much surprise at business reactions to its question as was shown by business at the question being asked so pointedly. The Bureau protests that there has been no change in policy. That policy is still to prevent avoidance of personal taxes and to collect revenue according to the instructions of Congress. No new instructions have been issued to field agents. Even before the war each agent was required, with respect to each return examined, to express his opinion on whether retention of earnings was reasonable or unreasonable, and on whether a penalty should or should not be assessed. Then as now there was an initial presumption in favor of distributions in the neighborhood of 70 per cent of earnings—a very tentative presumption, insists the Bureau, capable of being overthrown by almost any reasonable evidence of need for funds. Then why the question? Well, "102" had slept through the war and many had forgotten it.

. . . . all corporate returns are not examined in the field, and it would be a great administrative convenience to the Bureau's auditors to be able to see at a glance what was going on in this part of their field of responsibility.

. . . . moreover, the question asked for a corporation's *reasons* for distributing less than 70 per cent, which heretofore had been asked only in the course of field audits; asking it at this point was really more convenient for everyone.

. . . . did the "question" presage a furtive revival of the UPT? Why that charge? The UPT never distinguished as to the intent of withholdings, which the Bureau takes great pains to do under "102". Legitimate purposes were not recognized under UPT. Business itself has always vastly preferred the "102" type of approach to the UPT blunderbuss.

. . . . was the Treasury trying to recoup losses from the repeal of the excess profits tax, reduction of the corporate income tax to 38 per cent, and generous Congressional allowances for the dislocations of war and reconstructions? If so, something more potent than Section 102 would have to be found. Under prevailing judicial scrutiny it could rarely be made to reach other than the

closely held and usually small corporations*, and it is a safe guess that even with fanatical administration the revenue yield would remain small.

. . . . in short, the new question on the corporate income form does not signal a general witchhunt.

This position is no doubt formally correct. But most of the time policy does not really develop formally, and the following guess as to what may have happened within the concourse of people making up this big Bureau is permissible.

In early 1946 a writer for a widely read legislative service managed to throw a somewhat sinister cast around Section 102. Inevitably, inquiries began to pour in from industry. It then may have occurred to someone in the Bureau of Internal Revenue itself that, in the light of the big post-war surpluses being accumulated, an *official* reminder both to agents and corporations of the existence of that Section would not be amiss. What may have then transpired within the Bureau's heavy walls is of course their secret, but for those knowing Bureaus it is not hard to surmise a lively debate as to the wisdom of such a step. It might not always have been obvious that the interest aroused in the business world would have psychological by-products and that such a "question" would never be dismissed as a simple request for information. In many government bureau make-ups, the statistically minded people would be in favor of such a procedure, the operating people opposed. It may have been so in this case. The decision may have been merely that a corporation's answer to the question would at least assist agents in determining whether or not unreasonable surpluses were being accumulated, and that in any event corporations were in such a strong position that it would not hurt to nudge them a bit. The face turned toward the public would be innocent enough. Why should not taxpayers be required to explain this situation as well as any of the others reflected by their tax return?

d. *Why 70 Per Cent?*

A question still remains—and one that is bound to cause apprehension—as to why the Bureau hit upon 70 per cent as the point at which to start being suspicious. Historical data should be segregable more finely by size and industrial classification over time than is the case to justify a firm policy or even a strong presumption. In particular the need is for data on the percentage distributions of corporations widely held and narrowly held in relation to the tax brackets of income recipients, a type of correlation impossible to contrive from available records. Even so, the Bureau can make a plausible case for its figure, if it is granted that some kind of simple warning signal is needed to alert a large administrative staff dealing with endlessly diversified cases. In good years before the war, profitable active corporations in the aggregate usually paid out 67 per cent of earnings or better**, although the inter-industry and inter-size variations were very wide. During the war the ratio fell away off, but circumstances were extraordinary and no one looks to the war years for guidance on peacetime policy.

It would be a mistake in any event to criticize tax policy, any more than tax morals, on purely logical grounds. Both are heavily watered with expediency. In the present case the 70 per cent breaking point may have been partly suggested by a mixture of corporate reactions to the old UPT and of White House reactions to its repeal. When the Administration was fighting its last battle against repeal, it was reminded that after all old "102" was still on the statute books. Friends of the dying measure remained skeptical. Possibly as a result, TD 4914 was issued in July 1939 and contained the first reference to 70 per cent. This fortuitous number was thereupon widely advertised, and in its turn began to provoke inquiries from still suspicious Congressmen and corporate look-outs. TD 5398 issued in 1944 is sometimes cited as another strong hint that corporations would do well to let stockholders have 70 per cent of their annual earnings. The Bureau itself, however, seems to regard this TD 5398 as no more than a modification of internal paper work and of no particular interest to the public. Whatever the origin, time has given the figure considerable authority and the practical result is that suspicion begins at 70. The Bureau itself is nervous about the tendency of lawyers and accountants to take its debut in mathematical economics too literally, and would almost certainly warn at this point that the discovery by its agents of a lesser distribution in any particular case was to mean no more than an invitation to further inquiry. The Bureau's interest under the law must be not merely in the magnitude of the present sub-

---

* Even if widely owned corporations are found to have large surpluses, the basis for attack is not clear and there have been almost no attacks. It has always to be decided, of course, when the stock of a company is widely held. Section 501 (A) (2) of the Internal Revenue Code considers a personal holding company as one in which 50 per cent by value of the outstanding stock is held directly or indirectly by five or fewer individuals. In all likelihood, the same general rule serves as a point of departure at least for the administration of Section 102.

Present data do not afford a basis for determining the share of corporate assets or net worth which are held by concerns meeting the "personal holding company" criterion. It must not be thought, however, that it is impossible for the coverage of the section to go beyond small, closely-held corporations. For one example, a closely-held corporation can be rather large. Similarly, a firm (small or large) boasting many stockholders can have heavy concentration of ownership. The Ford Motor Company might conceivably illustrate the first case, while the second has been exemplified in a Court proceeding under "102" by a corporation with 2,200 stockholders which nevertheless was held liable to the penalty tax because a few controlling stockholders were deemed to have benefited personally from their company's retention of earnings. In such cases—presumably few, but capable in an absolute sense of being impressive—zealous administrators might be prone to attack, particularly if under the influence of an economic predilection for liberal dividend distributions. Due to the excitement raised by the Bureau's question, some speculation has arisen as to whether a drive overrunning old size boundaries is in prospect. Some observers who put their trust in court precedents feel that any such drive would have to be powered by personal convictions rather than zest to administer more perfectly this particular Act of Congress.

** See Table on page 27.

stantial corporate savings but also and primarily in the reasons why they are being made.

The principal value of this erratic history, culminating in "the question", may be in illustrating the difficult life of a patch in a cumbersome and ill-conceived tax system. The Bureau likes to say, and no one doubts its sincerity, that it is merely picking up where it left off during the war. Actually, it cannot do that, because of the vast change in types and spreads of income and of taxes to which it has to adjust. The present steep progression of presonal tax rates, the elevation of millions of families into higher income brackets, the present heavy corporate accumulations, the beckoning of new national and personal goals, a widespread feeling of expectancy because of the accelerated pace of scientific discovery, mingled feelings that our entire economy may be poised either for new adventures or for purging reaction or both—all these things are openly or subtly related, and in combination make new demands on our tax thinking. They are novel phenomena requiring a new evaluation of the functions of wages, prices, profits, capital, fiscal and financial policy.

Admittedly, Section 102 is petty in this company. It is a mere incident of incomplete fiscal thought. But it is bothering people beyond its deserts partly because of a perception of bigger things to which its kind of function is for the moment principally irritating. Doubtless "102s" will continue to be needed for the reason that unrelated and sometimes conflicting purposes will remain in the tax laws after the best we can do, but their function of reconciliation is a poor one and is valuable principally in keeping our attention fixed on the need to minimize the weaknesses in ruling tax, and for that matter economic, concepts. Undoubtedly the Bureau wants to use "102" only to prevent tax avoidance. The questions that arise are concerned not with the Bureau's sincerity but with such enigmas as whether any method available to it can escape having more general economic effects than any one desires, and climatically whether the tax system that requires such a provision is not shown to be faulty in ways that call for more basic correction.

Against this background let us turn to technical considerations and examine some of the standards the Bureau and the courts have evolved for applying Section 102 in particular cases. The experts have covered this ground at great length and in careful detail. Only the high points need be touched here, culminating in the Bureau's responsibility to decide how much capital a business needs for an unpredictable future.

C. Administrative Standards and Technical Considerations

First comes the law, which does little more than set forth general intentions. It has been cited. The Bureau of Internal Revenue must then indicate what it believes the law to mean, and has done so in numerous regulations, instructions to agents, and public clarifications. Individual corporations are bound to disagree with either the Bureau's interpretations or their application to particular circumstances, and ask the courts for relief. The Dobson case* made findings of fact by the Tax Court final, and as a result many cases are taken to the District Courts instead of the Tax Court in order to preserve the right of appeal on facts as well as law.

For general clues as to the significance that has been acquired by Section 102 with age and litigation there follows a condensed itemization of Bureau pronouncements and court decisions.

1. *Bureau Pronouncements*

In TD 4914 (1944), agents were instructed to examine closely the applicability of Section 102 to corporations which (1) have not distributed at least 70 per cent of their earnings as taxable dividends, (2) have invested past or current earnings in securities or unrelated business activities, (3) have made loans to officers or shareholders out of undistributed profits that might suitably have gone into taxable dividends, (4) are closely held or function as trusts, or (5) have retained larger portions of their current earnings than are considered necessary to the nature of the business, particularly when taken with previous accumulations, even though current distributions exceeded 70 per cent of current earnings. Previous to 1944, the fifth highly discretionary test was not stipulated.

Over ten years ago the Bureau sought to reassure corporations of its good intentions by listing a number of circumstances which would be sympathetically regarded, and it is to be assumed that these tolerances are still valid. Among them were special hazards of the business, its normal rate of expansion, contingencies and employment insurance and employee benefits that might properly require reserves, active use of available funds in normal activities, and the need for surpluses to buy materials, offset fluctuations in wage scales, safeguard accounts receivable or pay off indebtedness. Providing encouragement under 1947 circumstances are the provisions for contingencies, material costs, fluctuations in wage scales and the payment of indebtedness. A test that is probably too mechanical for a year in which new horizons may beckon is allowance for "normal rates of expansion", although the Bureau will probably do its best to straddle commitments and horizons.

Regulation 111, Section 29.102, however, is more aggressive. In that Regulation appeared two pointed qualifications. Agents were informed that a corporation might be subject to penalty on any accumulation of earnings or profits *even* though not unreasonable**, and

* *Dobson vs. Commissioner* 320 U. S. 489. It is not surprising, however, that regular courts to which cases are appealed from the Tax Court sometimes seems to fret a bit over this limitation.

** This probably is protective and little used. The law says nothing about "reasonableness". That is an administrative standard. Therefore, if evidence of avoidance even through reasonable accumulation should somehow come to light, the Bureau would be bound to attack it.

Considerations	*Importance of Considerations*	*Number of Times Appearing*
1. Expansion Problems:		
Expansion postponed by war	Controlling 2, A factor — 1	3
Plant modernization plan	A factor — 1	1
Further expansion	Controlling 2, A factor — 1	3
Expansion and improvement	Controlling 1	1
To replace old equipment	A factor — 1	1
To purchase equipment in anticipation of war shortages	Controlling 1	1
To finance increased inventories	Controlling 1, A factor — 1	2
2. Adversity Problems:		
Awaiting recovery of business	Controlling 2	2
To cushion war adversities	Controlling 1	1
Growing surplus still less than current accounts receivable	Controlling 1	1
Five years of consecutive losses	Controlling 1	1
Obsolescence of product and entry into new field	Controlling 1	1
3. Trade Relation Problems:		
Precarious customer relations	Controlling 2	2
To meet price cutting of competitors	A factor — 1	1
4. Miscellaneous:		
Incorporation was designed to protect principal stockholder against uninsurable business risks and not to avoid surtax	Controlling 1	1
Necessary to maintain trade and prepare for expansion; tax on stockholders negligible; loans to stockholders bona fide	3 special considerations combined in one case	complex and not tallied except for expansion item

even if it distributed a large portion of its earnings for the current year (in both cases, provided a purpose to circumvent individual surtaxes could nevertheless be shown). The same Regulation lays emphasis on the cumulative force of questionable features. If, for example, an initially suspect corporation proved to be a mere holding company, and in addition accumulated earnings beyond the reasonable needs of the business, such accumulation was to be regarded under the Internal Revenue Code as determinative of a purpose to avoid surtaxes on stockholders unless the taxpayer could show by unmistakable evidence that no such purpose was intended. Another admonition appears in Reg. 111 to the effect that "the nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business". As a strictly practical matter, it is the Bureau's experience and belief that resources held in cash are much better evidence that the accumulating corporation has serious business purposes for them in mind.

Here for the sake of technical completeness it should be added that the threat of Section 102 is particularly real for corporations recently converted to that legal form from partnerships and proprietorships. The Bureau is likely to be very much interested in the reasons for the change, especially when it is coupled with sudden parsimony in withdrawals from such a new corporation in comparison with those customary before incorporating.

2. *Court Pronouncements*

Court cases are not numerous. While because of the emphasis on individual circumstances they cannot be said to have developed a master pattern, mere reiteration has served to spotlight a few particularly dangerous practices. Even so, the following references must be regarded as merely suggestive of hazard. They are highly condensed, stripped of their protective legal verbiage, and in any event exact duplications of circumstances are rare. Their significance for individual problems must remain, therefore, a puzzle for lawyers and—if matters go badly—for the courts.

A frequency distribution of details featuring judicial consideration of 33 "Section 102" cases, divided into those won and those lost by appellant corporations, appears

Considerations	*Importance of Considerations*	*Number of Times Appearing*
Financial position strong and highly liquid beyond need	Controlling 2, A factor — 1	3
Loans to stockholders { sole — 5, plural — 3 }	Controlling 4, A major factor — 4	8
Holding corporation of sole stockholder	Controlling 1, A factor — 1	2
Rate of expansion commensurate with increasing sales	A factor — 1	1
Old modernization program unexecuted	A factor — 1	1
Investment in unrelated corp. or securities	A factor — 2	2
Unconvincing historical experience	A factor — 1	1
Depreciation in market value of invested assets	Controlling 1	1
Safeguard against hostile legislation that was merely rumored	Controlling 1	1
Ambition to become ultimately financially independent	Controlling 1	1

at the top of this and the preceding page.*

It would be pleasant if a corporation wanting to keep its money needed only to glance at a tabulation of this character and thus ascertain what conduct on its part would permit or forbid. As a matter of fact the precision in these tables is a little too daring. The positive and negative considerations shown are not clean reciprocals. In the main they trail off into degrees of quantity and quality that can end up by reversing their own original charges. While it is evident, for example, that the courts have frequently been sympathetic toward the plans of a corporation to expand or to renovate, it seems equally clear that the enjoyment of a strong and liquid financial position *beyond* the needs of the program would probably bar further accumulation without penalty.

With excessive caution, however, we are nowhere. Caution does not require us to pretend that the courts have said nothing at all. On the side of "improper accumulation" in particular what they have said is quite impressive. With all reverence for "the facts in each case", it is still plain as day that the courts do not like loans to stockholders by well-heeled corporations. In as many as eight out of ten cases they were disagreeably impressed by this circumstance, and in nearly half of such cases it was controlling. A moral is at least suggested. No matter with what smiling tolerance the Bureau puts a finger to its lips and signals for silence before you are actually challenged, if you make loans to stockholders you may legitimately begin to worry.

Suspicious loans and a plethora of funds for which the corporation seems to have no particular use seem to lead the parade of questionable acts. The courts have made other interesting remarks, however, which we are entitled to ponder. It is at least clear that war excuses are *passé*. The potential builder must now make his guesses about a less explicit future. Investments in other corporations? Yes, this would raise eyebrows, but nevertheless a demonstration that the money would be needed later for legitimate purposes could still be controlling. In the discussion of the Bureau's dicta, liquidity was seen to be in better taste—i.e., except in one's own business. Some of the agents seem to feel that once assets become fixed there is more of a tendency to cling to them. Indeed the Bureau might not be too critical—other conditions being satisfactory—if the corporation could show that it was able to free such funds for approved purposes on short notice, and did not instead attempt to substitute current earnings for them at the moment of actual need.

The disallowance of depreciation in the market value of assets is intriguing. Even an eye-filling surplus may disappear or shrink seriously with declining market values. If the effective value of carefully built up reserves is dissipated by forces beyond executive control, why should they not be built up again? If not, why were we taught Robert Bruce and the copy book maxims? Taxpayers may often be squeezed between logic and the law, although given the lack of permanence in market appraisals it is easy to claim too much for logic. Perhaps the Bureau's answer would be simpler. If need for the money had been imminent it should have been kept in secure and liquid form; if not, it should have been distributed to stockholders. In no event could appraisals be subject to continuous change. In real life prices and values move up and down. A low value in one year

* For this arrangement the circumstances thought to be critical have been extracted from case summaries published by a number of business service organizations, with particular reliance on the National Industrial Conference Board (*Business Record*, February 1946), the National Association of Manufacturers (special bulletin on "Improper Accumulation of Surplus", May 1946), and upon J. H. Landman's article, "Business' Next Tax Headache? Penalties on Retained Profits", *Dun's Review*, August 1946. More complete descriptions as well as specific case references may be found in these sources.

may be high a couple of years later, and a paper loss urged upon the Bureau's agent as conclusive in one year might be obliterated in the next. To keep even with either the market or the times, values would have to slide like a trombone. And in the end, if a corporation feels that the penalty is more than it can bear, it usually has available the disagreeable remedy of establishing its loss. One of the few cases carried to the Supreme Court happened to contain an appeal that the Commissioner be obliged to give more weight to unrealized losses. The Court's ruling was in effect that such paper losses were not in themselves a defense for failure to pay dividends although they might properly be given weight when occurring in company with other extenuating circumstances. In another case in which certiorari was denied, the value of the company's assets had actually fallen below its liabilities*.

In the last paragraph it was suggested that the "imminence" of a corporation's need for money might be important. J. S. Seidman, the National Industrial Conference Board, J. S. Landman in DUN'S REVIEW, and other professionals have warned about that word. Troubled as it may be about the limits of its duty, the Bureau may feel it necessary to resolve doubts against a corporation that builds reserves to meet merely possible emergencies, or to finance expansion in the indefinite future. In one case, even though the challenge of a competitor's new products was quite clear, the Tax Court decreed in effect that it could recognize only the immediate needs of the business and not vague future hazards. This question of the timing of new projects can really be quite maddening, as will be seen in the later economic allusions to it. However, once a commitment to expand or modernize is clear the Court has shown itself to be quite sympathetic. It recently overruled the Commissioner of Internal Revenue in quite explicit language to the effect that a corporation had every right to finance its growth out of its own funds rather than to resort to borrowing.

Smaller points have been made by both Bureau and courts that might turn out to be quite important to some individuals. Is a ratio of current assets to current liabilities of from 2 to 2.5 so sanctified in business practice that more generous provision might smack of hoarding? The Tax Court contented itself with observing that such a ratio seemed to be reasonable in the light of standard business practice. But in another case would a higher ratio be declared unreasonable? The sequel could follow at any moment, once a standard is thought to have been discovered. A more comforting note was sounded by the Tax Court when it ruled that failure to distribute the accumulations of prior years, even though they had been used to protect stockholders, was not warrant for the assessment of a "102" tax in the current year. Such a decision, of course, does not impair the right of the Bureau to impose a penalty on any addition to an already unnecessary accumulation.

The problem of evidencing a corporation's intentions is seen in several of the above examples to become bigger and bigger. It is not surprising that many of the experts urge an almost lavish expansion in corporation records. Records on dividend decisions, records on the ear-marking of surpluses, records on plans for expansion, records on the legal and economic reasons for all these things. Perhaps record keeping will be overdone. The surprise voiced by the Treasury at the tumult caused by its 1946 "question" has already been noted. Perhaps it did not envisage a new wave of records. Perhaps it wanted the job to be simpler than that. If so, it has trouble escaping the consequences of an indefinite law passed to hold other parts of the law together.

Finally, it may often be the combination in which various considerations are found, rather than the absolute weight of any single one, that is important. Conceivably, there could be investments in unrelated activities, *or* policies on the lives of officers, *or* purchases of land for which the corporation does not seem to have any likely use, *or* an unnecessarily strong liquid position, *or* (although the experts may revolt at this point) loans to stockholders—any of these separately, without bringing down the official lightning. But why *shouldn't* a combination of these be fatal if the provision is to mean anything? Not too many innocent men would suffer. Actually, it is the kind of a law suggesting mutual sympathy and restraint on the part of both corporations and the Treasury. The corporations can always overstress imponderables in equinoctial years such as the present. The Bureau for its part could make it very difficult for the corporations if it so desired, because of the burden of proof on abstract matters that is put on them by the revenue code and supporting court decisions.

D. The Economic Issues

It is the economic rather than the legal consequences of this kind of law, however, that invite purposeful discussion.

1. *When Is A Surplus Adequate?*

It has been seen that a heavy accumulation of earnings sets up a presumption of intention to avoid personal taxes. What is an accumulation, how much is heavy, why are present surpluses regarded so sourly, and what economic standards of judgment are there to compare with those of the law?

a. *The Statistical Background*

For reasons stated in an early paragraph, the Treasury permitted surpluses to be built up during the war because of the extraordinary known and unknown contingencies with which business was faced. It was in truth a handsome job of building and post-war losses have not yet

* However, in another case involving a substantial shrinkage in the market value of investments, real estate and equipment, the Tax Court ruled that "The assets would be useful to the business only to the extent of their actual market values . . . Thus the surplus based upon cost, as computed by the Commissioner, was not available for the reasonable needs of the business". As a matter of policy the Bureau prefers to follow the more severe rulings cited in the text.

shown up to cloud its beauty. Changes of a suspicion-arousing type have been both gross and internal.

From 1936 to 1939 surpluses fell by about $1.6 billion. Many corporations were losing money, others were distributing larger dividends than they earned. By 1940, conditions had improved sufficiently to permit about $750 million of this loss to be restored. (The Committee on Post-War Tax Policy reported, for *profitable* corporations, additions to surplus of approximately $3 billion in that year after taxes and dividends.) Then came the feast. Surpluses rose by over $21 billion through the next four years, and when later data are available they will probably extend this trend. (The U. S. Department of Commerce has recently set corporate undivided profits for 1946 at $6.9 billion.) A National Industrial Conference Board study of 14 manufacturing industries shows surpluses to have risen in a general range of from 30 per cent to 95 per cent from 1939 to 1944.

In terms of balance sheet composition current assets were benefiting principally. Business was becoming increasingly more liquid.* For 76 manufacturing groups, according to Frank Gastaldo of the Conference Board, cash and marketable securities increased in relative importance from 32.5 per cent in 1939 to 40.5 per cent at the end of 1943—a substantial increase even after allowance for tax accruals. Corporate holdings of liquid assets rose from $13.0 billion in December 1939 to a peak of $47.4 billion in June 1945, receding thereafter to $46.1 billion in December 1945 and $43.3 in June 1946**. From 1939 through 1944 corporate long-term debt declined from $44.3 billion to $40.9 billions***, a trend that was probably maintained through the war. Inventories declined as a percentage of current assets—partly, however, because a large part was government-held.

A revenue agent's nostrils quiver at figures like these. Great size, and then suspicious composition. Nevertheless, they continued to rise. Reconversion allowances (Tax Adjustment Act of 1945), compensation for inventory losses (Contract Settlement Act), accelerated amortization, tax carry-backs, the 10 per cent excess profit tax refund, corporate tax reductions, elimination of the excess profits tax, all in a period that for most corporations was one of continuing high sales and profits, helped to swell the coffers.

The Bureau itself caught a bit of the giving spirit, and began in 1945 to allow liberal current expensing of costs normally capitalized as long as they went toward returning the taxpayer's plant to a pre-war production basis (although the practical effect may not have been substantial).† Of course, there were expenditure offsets on many of these accounts. The imminence of extraordinary expenditures and of losses was frequently the reason for the government grants. But the over-all net results were good, dividend policies remained inexplicably conservative, perhaps as much as $30 billion may have been added to surplus since 1941¶, and the conviction of some officials that "they have built up lush reserves and still want to add more" is understandable.

Many of the corporations do not see it that way. Their grievance is that the Bureau, principally because of the necessity of doing something to discharge its obligation to "102", is applying old rules to new times. They do not themselves know what their new capital requirements will be, they do not know how soon or fast they can expand, they do not know what their capital costs will be and fear that they will be high, and they resent the implications of broad figures when both problems and practices vary so widely from industry to industry and among individual concerns. It is on small and intermediate corporations that the burden of Section 102 principally falls and it is precisely these concerns that are most dependent on their own resources for self-preservation and growth. Finally, the abuses that "102" seeks to correct are just as much the fault of the tax system as they are of the corporations, and if the government would put its own house in order most of its present grievances about corporate dividend practices would resolve themselves. Thus run the arguments and they must be examined.

b. *Uncertainty of Forward Capital Requirements*

Both the Congress and the Bureau were ready to bind up the financial wounds of corporations injured in war or reconversion. Now these particular hazards have passed, and in their stead large surpluses loom. Not unreasonably the Bureau feels entitled to inquire into the purpose of all this unusual money. The question troubling many economists is whether there are no new uncertainties deserving a tender bureaucratic touch. Few would regard the world as at rest. War uncertainties gave way to reconversion uncertainties, reconversion uncertainties will give way to what? Some economic soothsayers are gloomy, others foresee a golden age of industrial expansion. Heavy reserves would conceivably be needed to cope with either depression or boom. If there is even a reasonable prospect of big things ahead, is not the burden of economic proof thrown back on the Bureau whatever its prerogatives under the law? It voluntarily made allowances for economic uncertainties during the war, it can do so now if it wishes.

There is no lack of authorities who believe that an extraordinary period of expansion lies ahead and that present capital reserves will be strained to finance it. They point to the severe shortage of housing and office space, to long deferred plant maintenance, to our present dependence on a pre-war plant (only spottily augmented

* Liquidity was probably enhanced by the fact that the bulk of investment in new plant and equipment which made the scale of war-time output possible was for government account. It could be modified by later purchases of these plants by operating or other corporations, although not in scale because of the moderate to low prices that these plants will probably bring.

** *Federal Reserve Bulletin*, November 1946, p. 1237.

*** *Survey of Current Business*, September 1945, p. 14.

† For discussion of a contrary and perhaps undesirable attitude on research expenditures in "normal circumstances", see below, p. 31.

¶ Including retained earnings to about $26 billion, $1.7 billion for accelerated amortization, and at least another $1 billion on account of normal and excess profits carry-backs.

by war construction)* geared to a rate of national activity from a third to half lower than the rate now in prospect; to a world hungry for both capital and consumer goods that for a time only America can satisfy, to the priming properties of war arrearages in the twenties, to the possibility (in connection with pleas for tax reductions designed to increase the supply of investment rather than consumption funds) that the shortage of venture capital may eventually be one of the principal bottlenecks in sustaining high employment, and finally to the fact that these and other pressures upon supply in the constructional trades and equipment industries portend prices much above pre-war levels. On this basis they argue both that the reserves of many corporations are by no means as high as they sound and that they are only as high as they are because they cannot yet be wisely spent. They dismiss almost impatiently the vaunted liquidity of American business in the face of probable needs, citing an already realized increase of over $3 billion in borrowings since V-J Day that has carried the total to 50 per cent over pre-war levels.** In 1946 alone, bank loans for commercial, industrial and agricultural purposes jumped by over 40 per cent to $10.3 billion.

Some general support for this position may be found in many current forecasts, made without thought of the "102" issue, which count on expenditures of as much as $20 billion for plant and equipment in the forthcoming year. Most of this would be spent by corporations out of surpluses, current and future retentions, depreciation and other reserves, depending of course on the earmarking of these liquid assets at the time of need. Thus there might be a considerable draft on the "unconscionable" $30 billion accumulation of the past five years over the next two or three years***, and without any allowance for the very serious consideration that its distribution would not be well synchronized with needs. Those who are aware of the relationship of their analyses to the "excess liquidity" issue would probably indicate, too, that neither has the *ratio* of cash to sales risen nor the turnover of other assets declined in the period of accumulation.† The inference is that the new resources are frequently needed even now to support current levels of business, and that in many cases working capital and cash positions have been none too strong. Admittedly, these data overreach Section 102, but it seems improbable that the position of small and medium-sized corporations was sufficiently different from the average to warrant quite different conclusions.

We are dealing here with the mysteries of the future, and therefore with a mere state of mind insofar as business planning is concerned. States of mind can also be gloomy, and similarly call for conservation. For executives who chronically take a dark view of life, there is no lack of expert confirmation. Some economists look upon almost any run of prosperity as equivalent to living on borrowed time. They feel particularly secure in their melancholy in a period such as the present. After practically all wars, have there not been sharp depressions? Is not the consistency of that record more fully to be trusted than excitement over a few spectacularly favorable features in an economy that is complex beyond comprehension? At any rate, a few well known seers are proclaiming disaster and finding reasons for it that the laymen cannot set quantitatively against the different reasoning of the optimists. And if a depression it is to be, bingo go the prospects of calling on the money market for funds that may be badly needed. The moral

---

* The following comment is illustrative: ". . . . It was impossible to do the war production job without reducing equipment installations for the civilian industries to a bare minimum. As a result, the industries which produced civilian-type goods throughout the war probably had a poorer plant at the end of the war than at the beginning. . . . "(Ewan Clague, Commissioner of Labor Statistics in an address to the Society for the Advancement of Management, December 6, 1946.) The significance of this citation for the present purpose is of course qualified by the fact that 1946 expenditures at 2½ times the pre-war rate have already gone some unknown distance toward making good capacity arrearages. It is nonetheless interesting to note the frequency with which annual corporate reports are now endeavoring to calm the enthusiasm of stockholders by reminders of the extraordinary re-building and expansion costs that lie ahead.

** Emerson P. Schmidt, "The Economic Outlook for 1947", the U. S. Chamber of Commerce, Washington, 1947.

*** It has already been observed (p. 15) that corporate holdings of liquid assets declined by slightly more than $4 billion from June 1945 to June 1946, most of the decline occurring after V-J Day and in the face of continued heavy retention of current earnings.

As to the possible continuation of this trend, quite a few current analyses seem to support the general position taken recently by F. C. Dirks, "Postwar Capital Formation and Its Financing in the Manufacturing and Mining Industries", in *Private Capital Requirements* (Postwar Economic Studies No. 5, Board of Governors of the Federal Reserve System, Washington, 1946), p. 36. According to this economist, after the war (1) there would be a fairly large need for new industrial facilities, even in the metal products industries where most of the Government financed war plants are located, (2) corporations are likely to reduce substantially their holdings of liquid assets in order to finance expansion of other assets, and (3) in the industries where expansion of plant and equipment and inventories is largest, considerable outside financing will prove necessary.

In this same connection, provocative figures on the so-called "business account" for 1939, 1944, and 1946 appear in the recent "Economic Report of the President". They are not cited in the text because their usefulness is impaired by inability to make a clear separation of corporate and non-corporate items. As they stand, they show an excess of business expenditure over receipts of $16.2 billion in 1946. The record is further muddied for the present purpose by renegotiation and hangover tax adjustments. Even so, the previous inference is confirmed that expenditures of corporations in 1946 exceeded receipts (i.e., adjusted corporate profits after dividends plus depreciation, depletion, and other business reserves) by at least several billion dollars. The soaring figures on the expenditures side, in which we are principally interested at the moment, are for producers' durables and (possibly of temporary importance) inventories.

It is additionally interesting to note that, according to a recent survey, "Current assets of corporations expanded more during World War I than during the war just ended. Current assets of 81 manufacturing corporations increased 188 per cent from 1914 to 1918, which compared with an increase of 106 per cent for 673 corporations from 1939 to 1945 . . . . corporations during World War I showed a greater [proportional] rise in cash and marketable securities [than in World War II]". (F. Gaston and F. J. Mills, *Conference Board Business Record*, February 1947, p. 33.)

† Of related interest, an analysis of the balance sheets of 130 manufacturing corporations having sales or total assets over $5 million showed that while total current assets increased from $1,972 millions in December 1940 to $3,854 millions in December 1946, the current ratio had declined in the same period from 4.06 to 3.18. See *National City Bank Monthly Letter*, March 1947, p. 34.

is clear. Safety comes first, and by what right should the Treasury imperil it? It is the business life of the taxpayer that is at stake, not that of a government inured to living on deficits.

Such general considerations, however, cannot be coercive. The Treasury recognizes and is prepared to assign some weight thereto. But their final insinuation is that the Treasury should not for years and years pay much attention to Section 102, a course which would be hard to explain to Congress. Obviously the whole problem is one of degree, and in its search for a sound position the Bureau of Internal Revenue might well set the following considerations against those urged above.

First of all, dreams of America's future are a little melodramatic for the rather commonplace situations with which the Bureau has to deal. The facts are often quite clear. A corporation has piled up more funds than it has any plans to use and its principal stockholders are in the high income brackets. Almost anyone would suspect an intent to avoid, and his suspicion would not be lessened by the occasional legalistic contortions of the principals, as in loans by a flourishing corporation to its flourishing owners. The record suggests that the principal effect of some of the resorts has been merely to make the corporation more conspicuous, like a comedian trying to pose as a pretzel in a circle of interested policemen. This, however, merely carries us to the other extreme. The in-between cases are the hard ones and probably the more numerous—careful executives who want to bide their time before plunging into new ventures, or for that matter the normal majority which is not sure which way things are going to turn.

Nor is the Bureau completely crushed by challenges as to who would make the best use of all this money—the corporations, stockholders, or the Government? The Bureau really doesn't know. It merely wants to know whether the corporation has any definite business use in mind for it, and on what evidence. Otherwise Section 102 takes the matter out of their hands. After all, past records are not worthless. Standards of reasonableness as to the amount of reserves needed in various industries have been established by uncoerced business practice over the years. The presumption is that in accepting them the Bureau's economic errors are not likely to be too numerous or serious, and that sudden deviations may very well signify efforts to avoid surtaxes. An opponent may pause only because he is dealing over the next few years not with timeless standards but with the unknown, with the extraordinary uncertainties of what may be a new economic era. The past may very well be misleading. During the war, almost all business was reacting to very special circumstances, and before the war both profits and prospects were humdrum. Not at all irrelevantly, *why* are current dividend policies so conservative?* In the mass, the motive *could* not be to avoid taxes.

The Bureau could have another answer. Suppose general prospects are good. Is it essential to their exploitation that the function of amassing the necessary capital be turned over largely to the corporations, and in a manner coinciding beautifully with tax avoidance? Traditionally, the judgment of the market has been given a good part of the responsibility for distributing the nation's resources over competing needs. Natural persons also have money and like to invest it, while even fiduciaries have been a fairly prolific source of some kinds of venture capital. In good times new stock issues contributed substantially to the financing of corporate expansion. In the period 1923-29, for example, they totalled $14.5 billion as against $15.3 billion of income retained by all corporations. Both figures were low to negligible during the five worst years of the following depression, new issues approximating $2.0 as against over-all losses of $25.6 billion. The new capital issues, of course, went in part toward retrieving losses. Income retained by *all* corporations during the 19 years prior to the war rang up a minus $12.3 billion in contrast with new issues totalling $17.9 billion.**

But there is more to this question than new investment. Recipients might choose to spend their dividends, and thus indirectly contribute to the growth of corporations other than their own. Many economists would prefer to see the country grow around spending springs rather than around reservoirs. The aggregate influence on spending and investment could be of some consequence. In 1940, for example, dividends totalled nearly $6 billion. Furthermore, there is an interesting democratic touch about a recently observed tendency toward wider diffusion of dividends. In the period 1939-1941, the dividends paid to individuals and fiduciaries with incomes of $5,000 and over were in aggregate only 68.7 per cent of all dividends paid to individuals and fiduciaries filing an income tax return, as against an average of 86.2 per cent in 1924-26 inclusive. In 1941 the ratio ran only 65.8 per cent, backtracking to 67.8 per cent in 1942.*** Finally, strong stagnationists would under most circumstances regard it as helpful to the establishment of a higher rate of total spending to divert business earnings from corporations to stockholders.

Both the corporations and some economists would offer rebuttal. Opportunity costs, i.e., the *relative* appeal of expansion programs over alternative uses of available funds, may suggest delay. Money costs would in many instances be unduly increased by reliance on open markets. In particular, why pay unnecessary interest charges on expansion regarded as at least probable within the

* Preliminary estimates indicate that only 42.5 per cent of corporate net profits were distributed as dividends in 1946 as against a total of 50 per cent in 1945. See *Survey of Current Business,* February 1947, pp. 7-8 (Tables 2 and 4). However, over-all figures must as usual be used with reservations. Thus, one recent study shows that, for a sample of 152 *industrial* corporations (based on Federal Reserve data, and weighted possibly by large concerns), the ratio of dividends to net income was 66 per cent for the first three quarters of 1945 and 76 per cent for the comparable 1946 period. See Gaston and Mills, *op. cit.,* p. 38.

** See The Committee on Postwar Tax Policy, *A Tax Program for A Solvent America* (New York, 1945), p. 73.

*** Computed from *Statistics of Income.*

next few years? A court once said that corporations should not be forced by Section 102 into unnecessary borrowing, and after a great world convulsion, as later discussed, necessity is not to be neatly bracketed as short-range and long-range. The question is asked again: Why have not only war but post-war dividend policies been so conservative over-all, and even with numerous concerns having little to fear from Section 102? Furthermore, open markets are uncertain. They weakened suddenly and substantially (in the fall of 1946, for example) under the joint impact of declining values and a jam of new issues. Finally, it is never to be forgotten in this discussion that small and middle-sized corporations stand the nearest to its center. Open markets are not their dish.*

c. *The Issue of Immediacy of Need for Funds*

It must be made perfectly clear that the Bureau would honor many of the purposes of accumulation set forth above. But it wants immediate action or signs of it, and because of the nature of the times many corporations are not ready to act. It is understandable that an Internal Revenue agent would like to see actual commitments for expansion or replacement. Surely, if the taxpayer means business, at least preliminary plans should have been drawn. There should be more than just a general idea that it might be desirable to build or restore. And yet it would obviously be too much to expect corroborative evidence in every case. In the confusion attending emergence from a great war, many executives who know that they will have to build or make extensive repairs within the reasonably near future will see good reasons to hold off for some time.

The reasons for this hesitation are not obscure. During 1946, and especially in the last half of that year, CPA ceilings on non-residential construction were without doubt responsible for large-scale shelving of expansion or renovation projects. Moreover, even approval did not clear the way for action. Shortages of many building materials and types of equipment are still acute. Some companies may not wish to start construction or renovation when their executives know that they are likely to be held up time and again by non-appearance of critical supplies. Costs can be driven to exorbitantly high levels by continuous delay. In many areas an adequate supply of labor cannot yet be counted on, and to avoid even greater loss premiums may often have to be paid that will never be reflected in official indexes of wage rates. In the over-all sense there is at the present time no dearth of capital, but there can still be spells of uneasiness in the stock and money markets that will prevent finance officers, particularly of small companies, from arranging the kind and amount of financing that they prefer. Such difficulties are not imaginary. These few references are merely illustrative of exigencies carrying over from the war and that may not be cleared away for some time. It is tempting, and perhaps not too imaginative, to visualize men sitting everywhere waiting for the right moment to act. That moment may come shortly, or circumstances may not fall into exactly the right combination for several years.

It is, therefore, not difficult to challenge "imminence of action" as a fair test of reasonable accumulation. As a matter of fact the scorecard of some investors may run exactly opposite to that of the Bureau's. They may mark down their judgments of a corporation's management that is so reckless as to expand at present high costs and amid present uncertainties. It will inspire greater confidence if it waits. It comes as no surprise that, according to a recent survey of the Conference Board, some building programs are being deferred or reduced because of rising costs, labor problems, and uncertainty as to the general business outlook.** Drawing the line between prudence and hoarding is indeed one of the Bureau's headaches. At least, they have to take the position that mere words will not do, although crowded office or factory quarters might qualify as evidence. The law must be administered, and there is little to criticize about the delicacy and even embarrassment of the Bureau's approach to its task.

The Bureau also has a good technical answer to this point, an answer perhaps insufficiently stressed in many of the arguments provoked by its famous "question". Its routine methods of analysis automatically give a corporation a good deal of time in which to prove the sincerity of its intentions. A return for 1946, for example, is not filed until 1947. That return may not come up for examination until late 1947 or the middle of 1948. Already the subject corporation will have had nearly two years in which to act. In the end the Bureau might even permit the business that has overstated its case to make amends in the form of a 1948 distribution covering earnings of the previous two years as well as the current year. This escape assumes, of course, that the Bureau had accepted the officers' original assurance that they were planning to expand.

d. *The Issue of Insurance Against Rising Monetary Costs*

What tolerance would the Bureau allow for precautions taken against violent uprisings in operating costs, such as of raw materials and labor, and in maintenance and costs, and in costs of new plant and equipment? As a matter of sound business practice, should not higher reserves be accumulated against such contingencies? No one doubts that even after whatever settling process is to ensue, price, wage, cost and profit levels will be found at new levels and probably in new relationships as compared with pre-war experience. By December 1946, average hourly earnings in manufacturing industries were up 80.9 per cent over 1939, gross weekly earnings up 96.3 per cent, wholesale prices up 82.8 per cent, and those for building materials separately, 74.4 per cent. The new strength of the unions, the probably successful drive of organized agriculture for better than pre-war support levels, slowly receding shortages at home and abroad, the

* See p. 26.

** See *National Industrial Conference Board Preview*, January 4, 1947.

huge government debt and the tempting advantages in allowing its real value to suffer a moderate decline, the possibility of higher direct taxes and the partial reflection in prices of higher corporate income taxes, are among the many factors that will tend to hold up the money values of goods and services substantially above pre-war levels.

This outlook has to be differently evaluated with respect to different kinds of costs. Present corporate surpluses, liquid in particular, are ample even in relation to *current* labor, material and inventory costs. To the extent that the latter decline at all—and some decline is expected—the "real" value of liquid reserves will be higher still. Only against a further increase would the present abundant margin of security enjoyed by corporations in the mass be lessened. In the near term, however, a further increase in wage costs seems to be likely, and these will resist later reduction. Rising productivity and declining material costs will tend to compensate for their rigidity but that new relationships will have to be found is certain. Demand may balk at a further advance in prices and in the event of declines several billion dollars worth of inventory losses may have to be taken. No doubt many corporations have *planned* their reserves in the light of these possibilities.

Fixed costs are another matter. It has been estimated that the value of America's physical plant is now from 40 per cent to 50 per cent higher than pre-war, while depreciation and obsolescence is still taken on original costs. The Bureau once allowed a stepped-up rate of depreciation to compensate for more intensive use of plant and equipment such as occurred during the war. Eventually, however, this relief came to be given hesitantly or refused in many cases because the physical life left in the equipment was still greater than the rate of write-off had anticipated—particularly if a liberal allowance for obsolescence had also been made. Disregarding for the moment the modern argument that high depreciation rates may not be to the long run disadvantage of tax revenues, the Bureau's position can be understood. In case of sharp obsolescence, because of war improvements, for example, the old fashioned plant would have to be abandoned prematurely. The Bureau's attitude would be "wait and see", and in the great majority of past cases it feels that it has been justified. However, the present question is not one of a new rate of physical deterioration. It is one of substantially higher replacement costs for equipment and plant that is now undervalued. In this view, undistributed profits are not simply additions to surplus. They are in part a bookkeeping adjustment for inadequate depreciation reserves.

There is a small foretaste of this problem in one of the Bureau's own statements of policy, but it occurred long ago and was probably never made with any such situation as the present in mind. A press release dated September 17, 1934 promised that the Bureau would consider "any contingencies against which reserves ought to be set up" and the legitimacy of surpluses designed to "offset a fluctuation in wage scale". It is to be doubted, however, if the Bureau would regard this kind of tolerance as appropriate to the problems just discussed. In fact, it is not difficult to imagine the Bureau's answer. It could say that such upswings in cost, if they occur, are for the next decade of customers to absorb. If a corporation incurs new operating costs and higher investment costs against which to take depreciation and amortization, there will presumably be new prices—provided they do not break the market.

Corporation executives will probably not be satisfied with that answer. They recognize that costs and prices have fluctuated in the past, and that it would be somewhat farfetched to expect reserves to swing in harmony. Even so, they might argue, the 70 per cent suggestion of the Treasury will have all the earmarks of a fixed idea to nervous corporations and those lacking much contact with Washington, whereas in fact dividend policies have been quite sensitive to changing situations over the years. "Reasonableness" notwithstanding, business today has a healthy apprehension about what is going to happen. Did not disbursements (including taxes and dividends) exceed receipts by some $30 billion in the thirties? And do not unstable industries and concerns suffer even more acutely from their subjection in good years to undifferentiated tax rates?* Not always for "reasons", but to be safe in a period of general re-evaluation of all factors of production, they want reserves. Certainly among those reasons that they identify would be included the violent commotion in current costs to which they have to find some kind of adjustment. Perhaps next year's customers will pay for these, but next year's customers have already taken quite a rise in prices, and many executives are sitting outside of themselves today wondering when the break will come. In fact an immediate and voluntary paring of prices below those that the still nominal state of competition will tolerate in many lines is being urged both by economists and by many business men. Admitting the feasibility of such cuts as an instant corrective, the evolution of a wholly new scale of relationships among costs, prices and profits is still a much bigger matter.

As a final word, and quite apart from the question of hazards, it might be expected that the Bureau will allow higher reserves to match changes in the value of the dollar. That would merely be a matter of calculating suitability of reserves in relation to other dollar items in the balance sheet. All that that would prove, however, would be that more dollars will be allowed in surplus than before the war, leaving still open the question of what ratios are to be considered proper and what special

* Distress from this cause is now greatly, although not completely, alleviated by the two-year carry-forward and two-year carry-back provisions, the extension of which principle in modified form is elsewhere discussed. For data showing the degree of discrimination (ranging from moderate to absurd) which took place before enactment of these wartime palliatives, see J. K. Butters, "Discriminatory Effects of the Annual Computation of the Corporation Income Tax", *Quarterly Journal of Economics*, November 1939, pp. 51-72.

allowance, if any, should be made for the hazards of transition.

2. *Section 102 and the Undistributed Profits Tax: Similarities and Dissimilarities*

Ten years ago a bitter controversy raged over the undistributed profits tax. Today, memories of it have been reawakened by the 70 per cent question. It merits emphasis, therefore, that UPT and the Section 102 penalty are not blood brothers. They look at the same problem, but in comparison the gaze of Section 102 is almost embarrassed. At least that has been true of its administrators in their efforts to adapt it to changing circumstances over the years.

Nevertheless, the idea itself will probably survive as long as the present tax system because of its function therein, and it is as well to recognize that under pressure it can take on strange new forms. It is one of the off-center weights necessary to a misshapen and periodically shuffled tax structure. Under the pressure of its 1946 revival, will business move in the fascinatingly distinctive ways of 1936 and 1937 in its efforts to protect its cash? Inasmuch as the two measures have both common and independent purposes, and some very practical lessons were learned from UPT, it is advisable to compare them in some detail.

a. *General Evaluation*

The Undistributed Profits Tax was a long and militant step toward shifting tax emphasis from corporations to the people who owned them. To many analysts, the corporation has always stood provokingly and illogically between tax collectors and natural taxpayers. It fouled up logical relationships. Indeed in the form in which it was first proposed, the Undistributed Profits Tax was expected to supplant entirely the corporate income tax, excess profits tax, and the capital stock tax. Instead of taxing business enterprises as such, taxes would have been levied on corporate earnings when distributed and on retained earnings otherwise. But the new concept both as proposed and enacted did more than that, although it did it silently. In some minds at least it was to be the birchrod of a school of thought holding that corporations were absorbing too much of the nation's investment capital in depreciation reserves and undistributed profits, and that in a much larger sense opportunities for the investment of personally held and fiduciary funds were slowly closing. The theory of secular stagnation was coming into favor at the time. Part of the cure was held to be stimulating consumption. While dividends forced out of corporate profits would in major part be held for reinvestment, some would be spent. This was not a major line of attack on a problem that still looms large in economic debate. The roundabout and partial diversion of corporate surpluses into consumers expenditures could not occur on a big enough scale to cope with it. But it would help, and it meshed conveniently with the drive toward "tax equity". Even this much motivation can only be suspected. It would have harmonized with much administrative thinking of that day.

Section 102 of the Internal Revenue Code has nothing to do with this suspected if secondary motivation. It aims solely at the prevention of surtax avoidance by individuals. Because of the difficulty of sorting out the myriad and tangled lines between corporations and stockholders, it has come to be limited very largely in its application to so-called close corporations flaunting a few conspicuous owners.

b. *Specific Similarities and Contrasts*

Against this background the design and operation of the two measures will be contrasted.

Tax Rates. The penalty rates imposed for non-distribution of earnings under these dissimilar provisions are difficult to compare. The range of the UPT lay between the disarmingly moderate extremes of 7 per cent and 27 per cent culminating in an average of 20.5 per cent if all earnings were retained. The penalty tax under Section 102 is 27½ per cent on the first $100,000 of income subject thereto and 38½ per cent on retained earnings above that amount. However, the UPT applied to all undistributed earnings save for a small specific credit to corporations with incomes under $50,000. The portion of retained earnings to which Section 102 applies depends on circumstances, but as has been shown the history of its administration suggests that it is usually possible to retain 30 per cent without arousing serious suspicion. More importantly, a number of reasons for much heavier retention are acceptable under "102" which were completely and deliberately outlawed under the UPT. This great qualitative tolerance tends to make "102" much more lenient under most circumstances, but when it does hit the blow is harder.

Reducing Tax Burdens. Corporations found that they could soften the rigors of the UPT by financing cash dividends through bank loans or security flotations, and by deliberately increasing operating expenses. For 1936, 49 per cent of 618 reporting corporations* claimed success in lightening their tax burden through the second device, and even greater savings via the same means were planned for 1937. There does not seem to have been much resort to loans as dividend cover. The purposes principally benefiting from enlarged outlays were wages and salaries, advertising, and plant maintenance, in that order.

The same heroic remedies are available to corporations fearing an overdose of Section 102, just as they have always been available in minimizing normal and excess profits taxes. The temptation now, however, is not likely to be so strong where a case for retention of earnings exists that it is believed the Bureau will accept.

Enigma of the Tax Year. There were two complaints against the UPT on this score: (1) Dividends had to be declared and distributed while the year's earnings were still unknown, and (2) subsequent upward ad-

---

* See W. L. Thorp and E. B. George, "The Undistributed Profits Tax", *Dun's Review*, September 1937, p. 14.

justment of the net income figure by the Treasury could add to the tax without giving the corporation any chance to protect itself by supplementary dividends. There was a very articulate demand at the time for a period of grace ranging between 60 and 120 days within which to distribute adjusted net income without loss of credit; also for the privilege of making a secondary distribution for credit within 60 or 90 days after any Treasury revision of reported income.

These problems seem to be unchanged. The flagging demand for milder Treasury rules may be due either to the less biting nature of the present penalty or to the possibility that the Bureau's post-war offensive is not yet old enough to have stimulated a counterattack. Or perhaps under Section 102 the Bureau will at the time of audit give credit for distribution made after discovery of better-than-expected earnings.

Revenue Notes. There is no doubt that the Treasury was anxious to have the revenue that the old UPT would yield. As all taxes in those days were almost playful in comparison with the present burdens it is not surprising to learn that the actual yield was only in the neighborhood of $600 millions. How that figure will compare with the yield of the revived "102" at present levels of corporate profits and savings, it is still too early to say. Incidentally, there was considerable criticism of the tax at that time, on the ground that the revenues yielded by it would be unstable. Although agreement on tax policy is too much to expect, more experts today would be likely to subordinate tax stability to (1) restoration of order in the tax system itself, and (2) better synchronizing of our now huge center-of-gravity tax levies to swings in the business cycle. At any rate the concerns that the Treasury will be able to tap for "102" assessments will probably be small in number and small in size. Everything helps, but only on the scale of this cheerful inanity can the problem of adequate national revenue be said to be affected.

In part, both taxes merely borrow from the future. Under either UPT or Section 102 the Treasury suffers no complete or irrevocable loss when corporations fail to distribute their earnings generously. Corporate earnings may grow as a result of even deferred reinvestment and be subsequently taxed, or a capital gains tax may be assessed on ultimate sale.

Some initial irrationality in the tax assumes greater importance upon discovery that the real loss of revenue is never substantial even in the first instance and will be partially redeemed over time. Arguments at this point taper off into details that, while serious, can be merely mentioned here. Sponsors of the tax point to the possibility of later losses that may cancel out the increased net worth and with it the Government's hope for increased revenue therefrom in later years. Opponents retort that if losses are subsequently incurred the retention of earnings in a lucky year should not have been penalized anyway. Proponents complain that the owner may die and take his newly enriched estate beyond the reach of the income tax. The answer here falls among a variety of arguments about the proper size of inheritance taxes. Again, those wishing to press the issue protest the ability of corporations to concentrate disbursements in years of lean earnings and thus protect their owners from surtaxes in the rich years. Opponents really lie in wait for this argument. They believe that averaging is entirely defensible and that the Government should permit more of it—as in fact it is now doing implicitly, crudely, and incompletely, for corporations through the carry-forward and carry-back provisions. Individuals with irregular incomes are still the tax collector's cousins. Critics believe furthermore that one of the healthy uses that can be made of boom time earnings is to hold them off the market in a sort of economic escrow for release into the spending stream at the moments of greatest need—as in fact happened during the depression of the 'thirties.

This discussion must slide over a number of other aspects belonging properly in a discussion of revenue, principally the suggestion of triple taxation that is carried by this kind of tax—normal tax and surtax on corporations earnings, the penalty tax on delayed distribution, and personal taxes on eventual receipt with no credit for previous payments by the corporation. While this consideration has an obvious bearing on revenue, it is better discussed elsewhere.

Relation to Individual Ability to Pay. Corporation taxes necessarily affront the principle of personal ability to pay. Failure to allow for capital losses or carry-over of operating losses, double taxation, and penalty taxes merely aggravate the original offense. It could not be otherwise as long as (1) corporations are taxed as entities rather than as intermediaries, and (2) low-income as well as high-income stockholders must vicariously pay the same rate of normal and penalty taxes on their corporations. This paradox is not in itself enough to damn corporation taxes. There are reasons for them, such as the necessity of dealing with excess profits at the level on which they are earned, the appropriateness of charging for the privilege of incorporation, the disturbingly high proportion of personal incomes that succeed in escaping the tax collector's net (although perhaps not of dividend income), and the inevitable seepage of economics into policy and law as they touch "bigness" in these complex days.* But the co-existence of reasons and anomalies explains the many efforts made at least to find a different fit for them in the tax structure. A few of the resulting proposals are listed below (p. 27).

Small vs. Large Corporations. The incompatibility of UPT with the cyclical and dividend behavior of small

* See the dissent of Mr. Justice Brandeis in *St. Louis & O'Fallon Ry. vs. United States*, 279 U. S. 461, 488, in which he champions the right of the state to tax large corporate agglomerations for economic and social purposes as well as for money. Of course there have been many interesting tests under Anti-Trust laws of the power and duty of the Government to curb excessive size and preserve competition even if at some interim economic cost—with varying results over time. Modern cases include *U. S. vs. Aluminum Co.* and the recent American Tobacco opinion by Justice Burton.

corporations was one of the factors helping to bring about the repeal of that measure. Section 102 is heir to much the same ills, which have already been discussed.

Corporations vs. Partnerships. Of necessity, corporations and partnerships are unequally treated under our basic tax laws, and alterations in the impact on either merely alter the degree of discrepancy. Below a certain level of profit it is cheaper tax-wise not to incorporate. Both UPT and Section 102 tend to raise that level, assuming in the latter case retention of a larger portion of earnings than the Bureau approves. Under UPT there was no room for discretion—the major and immense distinction between the two measures. But the recent narrowing of the differential tax burden between partnerships and corporations at modest to high profit levels had the effect of enhancing the relative advantages of incorporation. As a result, post-war shifts in this direction are being scrutinized by the Bureau with particular care.

Special Groups. The effects of the old UPT on the lame and the halt were regarded by its critics as positively malign. Outstanding among those held to be victimized were debt-ridden concerns, cyclical and unstable industries, and those bound by contractual limitations in the disposal of earnings.

Debt-ridden concerns do not constitute a major problem under Section 102. Undistributed earnings are not taxed automatically. The Bureau has gone out of its way to assure business that accumulations to be applied to the reduction of business debt are not likely to be regarded as unreasonable any more than bona-fide investments in new plant. The propriety of the debt should be clear, however. Nor is retirement of stock from idle funds apt to qualify as a penalty-free debit to surplus.

Under the UPT there was no provision for averaging the results of good and bad years. Over time, therefore, it was possible for a "cyclical" or unstable industry or corporation to suffer a penalty tax on average net earnings of nothing flat, or even when the books showed a loss. Nobody liked that. Such a result, or anything resembling it, is virtually impossible under the criteria of Section 102. Moreover, the re-appearance* of joint carry-forward and carry-back privileges during the war, and the probability of their extension in some form, reduces significantly the tax discrimination against corporations with sharply fluctuating incomes. Ordinary losses may now be carried back two years and forward two years under the 1946 Revenue Act. There can be no carry-forward of unusual excess profits credits beyond 1945, however, because there is no excess profits tax, although unused credits for 1946 can still be carried back to the returns of 1944 and 1945. But against the ravages of "102" all that is permitted is a carry-forward of the preceding year's loss, and no carry-back at all. In any event a carry-back could not be very effective without an invention to retrieve dividends already distributed (under the threat of a penalty tax) and probably spent, although it would presumably be feasible to refund a penalty tax for failure to distribute. At this vulnerable point, therefore, business remains partially exposed to the fury of the cycles. However, at the administrative level, a record of cyclical instability may be put forward by a corporation as a defense against liberal distribution in a good year. The general subject is further discussed below.**

With respect to contractual limitations, the old UPT was regarded by some as positively berserk in its refusal to exempt earnings which could not be distributed without violating commonplace contracts. Refunding bonds, sinking funds, requirements of state laws, the contrary orders of Federal regulatory bodies, all were chaff to this tax in one degree or another. Section 102 invites no comparable recoil. The ungrudging allowances made by the Bureau for the discharge of legitimate obligations, old and even potential, were described in the early pages.

c. *Alternatives to Cash Dividends*

Among the more important matters meriting close consideration with regard to Section 102 is the possibility of resorting to noncash dividends. There are ways of satisfying the two-bit Moloch (as there were ways of satisfying UPT) other than by parting with hard money, but they must be such that the distribution is taxable to stockholders. In *Koshlund vs. Helvering* (1936) the Supreme Court ruled that 'where a stock dividend gives the stockholder an interest different from that which his former stockholding represented, he receives income.' Under this ruling, many small and medium-sized corporations were able to utilize various sorts of stock dividends to reduce the UPT burden. Since neither the Constitution nor the laws affecting non-cash disbursements have changed since 1937, a review of the status of such payments is worth a synopsis.***

Even after our experience with UPT, there are some uncertainties concerning the kinds of stock dividends for which corporations could or could not claim credit. The following classification, however, is generally thought to be valid.

Non-Taxable (No Credit)

1. Common stock on common stock.
2. Preferred stock on common stock, where common was the only stock previously outstanding.
3. Preferred stock on common stock, or vice versa, where both classes were held proportionately by the same stockholders.
4. Rights to non-taxable securities.

* A carry-back was allowed in 1919, abandoned in 1920, and re-instituted in 1921, continuing until 1928. The 1930 and 1931 Acts permitted a carry-forward, but this ran foul of the NRA Act. Thereafter no provision was made for reduction of prior losses until the 1939 Act, which provided a carry-forward for two years.

** See pp. 28-29.

*** For full discussion, see W. L. Thorp and E. B. George, *op. cit.*, pp. 8-12.

Taxable (Credit)

(In the first four cases, only when both classes are outstanding, and not identically held.)

1. Common on preferred.
2. Preferred on common.
3. Preferred on preferred.
4. Voting common on non-voting common.
5. Option of cash or stock.
6. Rights to taxable securities.

For several reasons, however, the difficulties of using even approved escapes are not small:

(a) The right kind of stock will usually not be available; new issues are awkward and costly and may have to be registered. The books will be full of fractional shares. In general, this is no business for small business.

(b) Dilution of preferred stocks may require the consent of original holders or provoke suits. Holders of preferred would likewise have to consent to accept common in lieu of cash where cash was stipulated. This is particularly awkward when dividends are in arrears.

(c) Market value of stock dividends will seldom be clear.

(d) Capital structure would be expanding without plan, sooner or later threatening serious imbalance.

(e) Options and rights may or may not be taxable to stockholders. Care has to be exercised, and certain persisting judicial uncertainties may defeat even care. At best rights are practicable only for seasoned corporations. Dividends—paid credits will not be allowed in excess of "fair market values," upon which the Treasury and the corporation may differ long after it is too late to make a new dividend declaration.

(f) The easiest escape, of course, is through consent dividends, which in the case of exactly the small and closely-held corporations on which so much sympathy is expended are a simple and practical expedient. The stockholder merely consents in writing to take-up in his own return any agreed-upon amount of his company's earnings just as if it had been paid in cash—assuming he has independent resources out of which to pay the personal tax. Or he could accept the cash and re-subscribe to new stock up to the amount not taken by personal taxes.

Corporations may also meet the tests of the law without losing cash by distributing earnings in the form of obligations, such as short-term notes, long-term bonds, interest and non-interest bearing scrip, debentures, income bonds, etc. Over time, however, this practice might result in a piling-up of unnecessary debt that could prove embarrassing, particularly in periods of depression. The problem of determining market values would arise here also—particularly in the case of scrip or promissory notes upon which the stockholders might realize only a fraction of the par value to which the corporation itself would be committed. Another general escape is to distribute in kind, although this raises problems with respect to determination of "fair market value."

It is proper to indicate difficulties, but not to the point of implying that all alternatives to cash are worthless. As noted, under the onslaught of UPT they were often used, particularly by the small corporations about which heads are most gravely shaken by critics of Section 102. Some of the difficulties are merely admonitory, potential, or even remote. For example, stock dividends need not always be registered and new overhead costs resulting from new obligations might not for a long time be of much consequence. In 1936, of 479 corporations surveyed by Dun & Bradstreet, 9 per cent combined cash dividends with some other form and 5 per cent—made up principally of smaller concerns—used non-cash forms exclusively. In 1937, the small people were moving even more decidedly toward non-cash forms—notably options and stock dividends. Closely held companies, now limelighted by Section 102, sometimes found a simple solution by requiring or requesting that cash dividends be reinvested—occasionally in return for stock or notes. The obstacles are partially psychological, born of inertia or unfamiliarity, and in the right situations might gradually be taken in stride.

In summary, the general difference between UPT and Section 102 it is readily discernible. The UPT was largely automatic in its application, making scant allowance for the real life worries of management, while the sanctions of Section 102 are applied if and when. There is reason to believe, nevertheless, that the latter are forcing out a considerable volume of dividends that for good business reasons would not otherwise be paid. Actually, we will never know whether the Bureau would have required their payment on the scale being realized. Because of the prismatic effects of private fears and private intentions, it will never be possible to compare the final results of Section 102 with those of UPT.

3. *Sidelights*

A number of special considerations influence the amount of money actually forced out by Section 102, and do so diversely.

a. *A Small Tool for a Presumptuous Job*

A distinctly limiting factor is that Section 102 can deal only with the fringe of an accumulated surplus, being addressed exclusively to the earnings and distributions of a particular year. The fringe could, of course, run deep in some instances. But it is the awkward logic of the law that is really trapped at this point—again. What would the Treasury say if current profits were small but surpluses huge? Whatever it did would be inconsequential. What we have here is that a government Bureau, although expected to define what surplus is reasonable in each case, is unable to do anything about it except with respect to year by year increments.* Indeed, in case of a general business refusal to disgorge and judicial com-

* As a technical matter, the Bureau can reopen old returns for the three years permitted by the Statute of Limitations. For example, a concern permitted to retain earnings for the financing of war production might still be penalized if the plea of need proves not to have been made in good faith.

plaisance in interpreting purpose, the Bureau would be obliged to determine the best disposal of a not inconsiderable part of America's resources. It is saved from that catastrophe, not by principle but by the two anomalies just cited—namely, that it can touch only one year's increment at a time and that it seldom can prove the intent of big corporations to avoid personal surtaxes. The result is that a big idea, because it is too big, fades into a mousetrap for small business. This happens because the test of "need for capital" overshadows the objective of preventing small scale tax avoidance. A minor tax law is hardly the instrument with which to force public policy on the use of private resources.

b. *It May Pay to Pay*

Psychologically, it has been seen, the suddenness of the Bureau's question may be forcing out more dividends than the Bureau would actually require. Paradoxically, if a corporation's object is really to protect its stockholders, it can better do so in some cases by paying the penalty. An illustration will be helpful. Assume first a corporation with three stockholders, each owning one-third of the stock and having no other source of income. Assume a net taxable income of $500,000, and an expectation that the Treasury will regard retention of more than 30 per cent after regular corporate taxes as "improper." Assume (for the moment only) that stockholders eventually hope to realize any retained earnings through a sale of stock, thus subjecting them only to the capital gains tax of 25 per cent. The steps in the following table will be self-evident up to the crucial question:

1. Taxable net income	$500,000
2. Normal corporation tax and surtax (@ a flat 38%)	190,000
3. Net income to be retained or distributed	310,000
4. "Reasonable" retention according to the assumption	93,000
5. Possible amount of improper accumulation	310,000 ~~217,000~~
6. Where is the breaking point, "vis-a-vis" tax saving, between retention and distribution of Item ~~#5?~~ #3?	

Each stockholder's share of the 310,000 ~~$217,000~~ awaiting disposal would be 103,333 ~~$72,333~~. The problem now is to find the volume of distributed earnings at which the *marginal* rate of personal tax on each stockholder's current dividends would equal the combined percentage rate (penalty tax for accumulation and the ultimate capital gains tax) on the corporation's "~~improper~~" savings. This can be done either by mathematical formula or by experimentation. That point is found to be reached with the distribution to each stockholder of $22,000 or a total of $66,000, leaving a balance with the corporation of 244,000 ~~$151,000~~.

The relationship is not difficult to test. At 1946 rates the levy on income between $20,000 and $22,000 is 53.2 per cent, and that on income between $22,000 and $24,000 is 56.1 per cent, whereas the combined rate applicable to "~~improperly~~" retained earnings in excess of $100,000 is 53.9 per cent (38½ per cent of this excess plus 25 per cent of the remaining 61.5 per cent). If, therefore, after distribution of $22,000 per stockholder the corporation would be left with "~~unnecessary~~" accumulation exceeding $100,000, it would be profitable for the corporation to retain the increment. In the present case, this means that a grand total of $151,000 would be kept. Further distribution would raise the absolute personal income tax per shareholder by more than it would reduce his share of combined Section 102 and ultimate capital gains liability, whereas the reverse would occur were the corporation to accumulate additional amounts.

Now no case that assumes ultimate realization by stockholders of exactly the retained amount of savings in the form of capital gains or places profits at $500,000, can be regarded as typical. It is also legitimate, however, to hope for sufficient reductions in present income tax scales, over time, to compensate for penalty taxes absorbed currently—although the reductions would have to be much larger than now seems probable. Death of the stockholder, of course, will bring the inheritance tax into play, but it is to be remembered, as in the case of the regular corporate taxes, that it would in most cases have to be paid anyway (although the capital gains tax would be avoided). A really easy choice would be presented if our three stockholders also had other sources of income which lodged them in high personal brackets, or in conjunction with dividends from this particular corporation would carry them there. In such event any substantial distribution of even a much smaller volume of profits would be all but devoured upon emergence from their corporate shelter—including the amount that would otherwise have been paid as a "102" penalty. Its escape would be brief, thus making the stockholders' actual cost of waiting for a better break from moderate to trifling. It is only the low income stockholders of penalized corporations who are certain to suffer under Section 102, and they would have to take their chances (although some might sue). And if for any reasons previously suggested the corporation was not trying to avoid, and really wanted the money for long-range contingencies that the Bureau could not recognize, the penalty would be undeserved. In short, a tax which seeks primarily to reconcile dissident major purposes in the tax system is always in some danger of miscarrying.

II. TAXATION OF SMALL CORPORATIONS: THE SHORT-TERM PROBLEM

A. Basic Objectives

As a tax, the Section 102 penalty is not important. It produces little revenue, and that revenue is not even segregated in otherwise elaborate Treasury records. Its importance is in its economic implications, in its unconscious malice toward small concerns, in the theory under which it penalizes such firms, in the prominence it gives to breaches in the tax structure by the very clumsiness of its efforts to plug the holes. Some cases, of course, will continue to be simple. Personal holding companies, and obvious evasions such as loans to big stockholders, do not suggest revolutionary enterprise. But beyond these, and especially in the domain of small business where the tax strikes hardest, the issue loses most of its moral stamp and poses impossible questions of degree. Here the task of discouraging personal surtax avoidance *via* inordinate corporate accumulation abuts that of insuring more liberal tax treatment to small corporations in order to provide a healthy post-war environment for competitive, venturesome business activity. It is perhaps in this field that the major significance of "102" is to be found. For this reason, it seems appropriate to conclude the present study with some comment on this general subject.

The main issue may be set forth very briefly. On the one hand, the economic climate is unfavorable in many respects to the development (and often continued existence) of small and especially small new businesses. On the other hand, it is largely upon the activities of such concerns that we must depend for vigorous competition, rapid innovation, and a high level of investment in the calculable future. To realize these objectives, that is to say, it will be essential not only to reduce (or even eliminate completely) discrimination against small enterprises, but perhaps to discriminate slightly in their favor. The problem goes beyond taxation, but it is insoluble without extensive and drastic tax reform.

There are three major aims of tax policy in this connection:

1. To enhance the relative attractiveness of risky, long-odds investment to small enterprises and potential entrepreneurs.

2. To make outside equity capital less difficult to attract on reasonable terms.

3. To strengthen retained earnings as a source of financing expansion of going small concerns.

These aims are not completely independent, but each presents enough special features to warrant separate treatment.

1. *Encouragement to Risk-taking*

Recognition is general that, insofar as concerns compensation for risk-taking, the burden of our present tax system weighs very unevenly and inequitably not only upon different industries, but upon different sizes of firms within a given industry, and upon the kinds of activity into which a given firm has the option of channelling its investment funds. To take the most prominent case, as matters now stand, a business enterprise is unable to deduct net losses of a given year from positive income of earlier or later periods save in the approximate amount of such income and for a rather short period. This tends, first, to discriminate against those industries which bear the brunt of cyclical fluctuations. Secondly, it penalizes small corporations in those fields—and they may be numerous—where their years of substantial income occur relatively less often, and those of deficits more often than for large established concerns. And lastly, it places a tight rein on innovating activities which have a risk-coefficient much above that for routine operations or expansion. This last effect in turn is felt most strongly by small new enterprises seeking to develop new products and processes—precisely the sort of venture it seems most important to encourage. A similar, though less sharp, pattern of discrimination arises from other elements in the system (notably present rules for depreciation and the increasing tendency to regard outlays for research and development as capital rather than currently deductible expenditures for tax purposes) which limit the extent to which "true" costs may be taken into account in computing net income for a given year.

Exactly how much of the unfavorable showing of small corporations may be traced to these biases in the tax system is difficult to say. Crude statistical correlations of losses with size of firm, for example, tend to overstate the effect, if only for the reason that many of the losses shown in fields dominated by small owner-manager type firms reflect at least in part large salary payments to escape corporate levies and thus reduce the total tax burden. Moreover, past experience suggests that maintenance of a high and more stable level of activity will implicitly do away with a good part of the present inequities.* But matters cannot and need not wait upon achievement of the latter goal, and in any case it would seem important to go beyond what might be done in this indirect way. As one authority has put it: "There is no principle of taxation, either in terms of equity or in

* For all industry, illuminating evidence to this effect for the period 1931-1941 may be found in J. L. McConnell, "Corporate Earnings by Size of Firm", *Survey of Current Business*, May 1945, pp. 6-12. Comparative analysis of data for 1939 and 1941 by major industrial groupings, given in the same source, indicate that the same conclusion is valid for each separate field except retailing.

terms of effects on production, that warrants the discrimination resulting from failure to carry over losses."* Both in the short-run and over the longer term direct action on this front seems eminently desirable.

2. *Accessibility of "Outside" Equity Capital*

Most economists would agree that taxes are not the exclusive, or even primary obstacles to a larger relative flow of "outside" capital to small enterprises on favorable terms.** There are, however, several respects in which the present structure seriously impedes such a flow:

(a) The asymmetrical treatment of gains and losses tends not only to restrict the activities of going small businesses, but to scare away outside investors and to dampen entrepreneurial enthusiasm.***

(b) High corporate and personal income tax rates coupled with inadequate loss-offset provisions have given rise to a trend of investment from equities to such assets as corporate bonds, life insurance, and government securities. Save in the case of government securities, this is not too unfavorable to large corporations since the latter can often obtain funds from insurance companies and since in any event the deductibility of interest as a cost in arriving at taxable corporate income places a positive premium on debt financing. Small units, however, find it virtually impossible to float debt issues or (owing to "diseconomies" of small-scale financing) attract insurance company funds. The result is a further evaporation of their long-term capital sources.

(c) Perhaps the major reasons for inability of small corporations to obtain short-term and medium-term credit have been inadequate working capital and inadequate net worth. These in turn derive in substantial part from tax policies limiting the supply of internal funds *via* retained earnings (see below) and the availability of "outside" equity capital.

Mitigation of these discriminations must be one of the prime objectives of any sound program for post-war tax reform.

3. *Assistance to Financing via Internal Sources*

The present corporate tax pattern appears at first sight to offset (or to mitigate substantially) its general discrimination in favor of large enterprises through the preferential treatment which its graduated rates afford to small firms with respect to internal funds. That such graduation is superior in this regard to a *flat* tax giving the same total yield cannot be gainsaid. But for several reasons it seems doubtful whether even this advantage succeeds in putting at the disposal of small concerns a larger volume of internal funds relative to investment needs. First of all, effective rates do not rise steeply up to $25,000. In the second place, the marginal tax rate on income between $25,000 and $50,000 is higher than that on incomes above the latter amount (53 per cent against 38 per cent under the 1946 law. This is the "notch" provision to which so many small and medium-sized firms object). And finally, as a rule small companies do not have much in the way of non-cash expenses (principally depreciation and depletion allowances) which, when earned, provide large firms with a substantial volume of "tax-free" receipts for internal financing of innovations and plant renovation and expansion.† From the viewpoint of its effects on the availability of gross income for investment, it is questionable whether on balance the tax system favors the little fellows.

It is not too important, however, to determine precisely how and to what extent the present corporate tax structure discriminates among sizes of company in its effects upon internal financing. The real points are that (1) at best the system cannot be more than slightly favorable to small concerns in this respect, and (2) the structure places a heavy absolute burden upon such firms since the latter must depend so largely upon reinvestment of earnings for whatever expansion they are able to effect. In this connection, the table on page 27, relating dividend policy to corporate size for the period 1931-1941, is most instructive.

These figures, it will be seen, evidence a sharp and amazingly consistent negative correlation of percentage of earnings withheld with size (i.e., a positive correlation between size and relative dividend-distribution) both for the period as a whole and (save between the "Under $50,000" and "$50,000-100,000" asset classes) in all cyclical phases. The inverse relationship between withholdings and size as measured by net worth over the same period is even more dramatic, the ratio for the smallest class exceeding by more than ten times and four times those for the largest class and for the average of all classes respectively.

---

* H. M. Groves, *Postwar Taxation and Economic Progress* (New York, 1945), p. 145.

** A very useful summary discussion of this whole subject, together with references to the pertinent literature, may be found in J. K. Butters and J. Lintner, *Effect of Federal Taxes on Growing Enterprises* (Boston, 1945), Chapters VII and VIII. For further treatment of problems relating to long-term "equity" financing, see R. A. Foulke's contributions to *Small Business: Access to Capital,* Bulletin No. 15. U. S. Senate Small Business Committee, 78th Cong., 1st Session, 1943.

*** Case studies by Butters and Lintner (*op. cit.*, pp. 137-222) suggest that the present tax pattern is less likely to deter managements from launching small new enterprises than from expanding operations once they acquire a foothold, whereas "outside" investors are much more willing to participate after some evidence of success than to gamble from the outset. The preferential tax treatment accorded to capital gains is a significant determinant of behavior of such investors. This factor operates to moderate the dampening influence of high personal income tax rates upon financing for small concerns noted in (b) above.

† This is not to deny the need for much more freedom in depreciation accounting, especially with regard to charges for obsolescence. For large, established concerns, however, the odds are that given a moderate degree of technological progress and stable or declining prices any under-allowance for obsolescence will be offset by the increasing productivity of capital which tends to reduce replacement costs in general and thus render depreciation charges excessive. It is only when (as at present and in the recent past) prices for plant and equipment have risen sharply that the combined allowance may prove inadequate to permit a flexible investment policy for such firms. This holds a *fortiori* for mining, quarrying, and oil industries where generosity in depletion allowances has been notable.

Percentage Retention of Net Profits After Taxes, Corporations with Net Income, 1931-1941

(Asset Size Classes in Thousands of Dollars)

Year	*Under $50*	*$50-100*	*$100-250*	*$250-500*	*$500-1,000*	*$1,000-5,000*	*$5,000-10,000*	*$10,000-50,000*	*$50,000-& Above*	*All Classes*
1931	57.3	47.8	39.1	32.1	26.4	21.5	13.9	11.1	3.7 d	9.6
1932	39.9	31.5	31.6	28.8	26.1	20.8	12.6	7.6	8.9 d	4.3
1933	64.0	66.5	61.4	61.3	56.5	47.1	39.4	22.2	2.5 d	24.0
1934	53.7*	57.1	52.6	45.5	34.9	25.8	28.5	3.5	13.9	19.7
1935	56.4	52.0	48.5	44.5	34.7	28.2	20.5	8.0	19.8	23.0
1936	35.8	28.4	23.8	22.7	25.8	25.9	22.3	15.6	4.9	15.1
1937	30.4	29.4	24.1	22.8	23.2	22.2	20.7	16.0	8.3	15.1
1938	50.6	54.8	48.3	39.3	37.8	29.5	23.7	16.8	7.3	19.2
1939	62.0	63.1	55.6	46.1	44.6	37.8	33.9	24.2	18.3	28.8
1940	62.2	59.2	56.4	51.2	50.1	44.3	39.0	30.1	22.3	33.2
1941	71.4	72.8	67.9	62.9	59.5	52.2	45.2	35.7	29.1	41.4
Avge.	53.1	51.1	46.3	41.6	38.1	32.3	27.2	17.3	12.6	21.2

d—indicates an excess of dividends over net profits after taxes.

* This item represents non-financial corporations only, because of the abnormal dividends paid by financial corporations of this size in 1934. Basic Source: *Statistics of Income*. Calculations for 1931-40 as given in Butters and Lintner, *op. cit.*, p. 66.

In both cases, there is widespread agreement* that small and growing enterprises—precisely the sort to which most encouragement should be lent—must both earn and retain profits much above the average for their size-classes if they are to realize their potentialities. A tax system which prevents achievement of these objectives, therefore, would seem to stand in need of improvement.

B. Instruments: Nature and Appraisal

It is not our present purpose to take the foregoing considerations as a framework for examining proposed major post-war tax reforms from the viewpoint of their implications for the economic status of small business vis-a-vis its large competitors. Virtually without exception the major suggestions—allowance of complete deductibility of losses, institution of averaging for personal and corporate incomes, integration of personal and corporate income tax structures to eliminate double taxation of dividends, modification of the present personal income tax rate structure,** and perhaps placing capital gains within the revised rate scale—seem likely to affect the degree of discrimination among different sizes of corporations. It is not possible to examine each of these in detail, much less explore their interrelationships, within tolerable limits. But other courses lie open. There are many measures short of a full-scale recasting of the system which might provide direct short-term relief for the smaller concerns, and the literature is pock-marked with discussion of their relative merits in *re* equity, administrative feasibility, impact on yields, effects upon investment, and consistency with subsequent over-all tax reforms. Since it is upon such measures that debate over small corporation tax relief will center, a critical summary of their pros and cons should prove useful. By this approach it will be possible to set forth the competitive and complementary relationships between

* See Groves, *op. cit.*, p. 102, and R. A. Musgrave, "Federal Tax Reform", in *Public Finance and Full Employment* (Postwar Economic Studies No. 3, Board of Governors, Federal Reserve System, Wash., 1945), p. 36. The Butters-Lintner study, indicating how often and how closely several (now-successful) small, enterprising organizations came (or would have come) to failure due to heavy tax burdens, illustrates this point negatively. As these students note, the effect of a high corporate income tax rate is likely to be cumulative in character, tending over time to limit the degree of internally financed expansion by much more than the margin by which it exceeds a lower tax.

** This step carries much wider implications for small business in general than for small corporations, since reduction of high surtaxes has a direct relationship both to the volume of "internal" earnings available to unincorporated concerns and to the supply of outside capital for such entities. There is agreement even among economists so far apart as Slichter, Lerner, and the late Henry Simons that within limits the dampening effect on investment of the present rate pattern tends to outweigh any support to consumption which it may provide through a more even distribution of disposable income. Some stagnationists mourn over the depressing effects of our "closed frontiers". To some undetermined extent, some have held, they have been closed not merely by geographic saturation and economic maturity but by high surtaxes. It is difficult to determine precisely what adjustments are desirable here, however, and in any event it seems preferable to postpone wholesale revision until decisions are made with respect to averaging of personal incomes, treatment of capital gains, other elements in the tax system, and the proper range of yields. For several years at least, it seems doubtful whether any strong stimulus to investment will be necessary—indeed, the near-term problem may well prove to be holding expansionist forces in this area in check. Now is the time to make the necessary preparations, but actual changes can wait upon evidence of declining demand. Meanwhile, preferential treatment of small corporations of the sorts discussed below together with the "partnership option" would mitigate the present discrimination against small enterprises in general.

the measures and to indicate their significance for Section 102.

To render discussion manageable, it has been necessary to confine consideration to major and widely advocated (or widely criticized) proposals for relieving small corporations (i.e., those with assets, say, of $1,000,000 or less) through legislative or administrative changes in the corporate tax system. The following meet these criteria:

1. Liberalized treatment of net business losses.

2. Further graduation in the rate structure (including exemption of some part of income as the extreme case).

3. Granting small corporations the privilege of reporting as partnerships for tax purposes.

4. Allowing more rapid depreciation of capital assets.

5. Liberalizing the treatment of such costs as expenditures for research and development.

In each case, the discussion will assume that the reaction to any given change in tax rates or definition of taxable income will be as though the previous tax load had been borne by the corporation, i.e., that there has been no shifting of the tax to consumers *via* price increases or by lower payments to factors of production. This may not be wholly true, but general economic considerations suggest (and economists are agreed) that it is true in substantial part; and to that extent both the general argument and the quantitative estimates will remain valid.

1. *Carry-forward and Carry-back*

Perhaps the most widely advocated change in policy on the "large vs. small" matter is to allow deduction of net corporate losses against positive earnings over a much longer period than now permissible. The basic aim, that is to say, is to redefine net income in such wise as to provide for a partial averaging of the latter over time for tax purposes. With a more liberal allowance, only corporations with consistently positive but nonetheless sharply fluctuating incomes would fail to benefit.

Achievement of this objective may be had by extending the accounting period backward, or forward, or in both ways. Wartime legislation, taking the last option, granted a two-year carry-back and two-year carry-forward. For the post-transition period, however, the weight of opinion seems to favor primary reliance on a carry-forward. Carry-backs have the advantage of providing previously profitable corporations with immediate refunds in case of loss, but would require the Treasury to maintain accounts open (or reopen same) during the specified interval, might pre-empt too large a share of the Federal budget in time of recession, and would discriminate sharply against new concerns. None of these shortcomings affect the carry-forward. For these reasons, most students seem to prefer linking the possibility of loss offsets to future profits much more than to past profits.

Agreement is less widespread with respect to the duration of the offset-period. If carry-back is used at all, administrative considerations alone would seem to dictate not more than one or two years, during which returns are likely to remain open in any case. But carry-forward is another matter. Assuming some degree of limitation—and there are reasons against indefinite extension—a period corresponding to that of the business cycle has much to be said in its favor. The duration of cyclical movements, however, is seldom constant, nor is it possible to forecast any given cycle accurately. Specialists, therefore, have been thrown back on judgment. As a rule, preferences seem to run around six years—perhaps for the reason that the English system is of roughly that length.* Several analysts, however, recommend a somewhat longer interval, while there is some support for five years.

It should be borne in mind that a more liberal loss carryover scheme, although tending to improve the relative position of small corporations, is unlikely to eliminate all discrimination against the latter in connection with investment risks. There are several reasons. In the first place, losses on a specific venture in any given year may push a firm into a lower normal (and/or surtax) bracket, thus placing the size of any tax saving below the liability attaching to the prospective gain. Secondly, inter-temporal offsets could be made only to the degree in which subsequent incomes are adequate to balance the initial deficit. And finally, in and of itself failure to provide relief pending the appearance of positive earnings may place a serious handicap on venturesome investment.** It is only small (and especially small, expanding) firms which suffer from all these handicaps. Large, established concerns, as a rule, have substantial liquid assets, ready access to capital markets, and (save perhaps in a few highly cyclical industries) sufficient positive income to render possible substantial deduction of losses within a short period of time. Even with a relatively low ceiling upon the permissible amount of offsets***, or limitation of the privilege to small corporations, some discrimination might remain.

The impact of lengthened carry-over periods upon revenues is difficult to estimate, since it will depend not

* Strictly speaking, since 1932 the English law has allowed business to deduct the lesser of the balance of any loss or the total depreciation, set off within the six years preceding such loss, without time limitation. See Groves, *op. cit.*, pp. 143-144.

** Complete elimination of these biases would require the government to share in deficits to the same extent that it shares, or would share in profits (i.e., to subsidize losses) during the period in which such deficits occur. To date, no one seems to have proposed so drastic a solution; but similar schemes, applicable in a system having a flat proportional tax, have been suggested by A. P. Lerner, "An Integrated Full Employment Policy", *International Postwar Problems*, Vol. III, No. 1 (January, 1946), pp. 103-105; R. A. Musgrave, *op. cit.*, p. 33; and A. H. Hansen, "Stability and Expansion", in *Financing American Prosperity* (New York, 1945), p. 242.

*** This has been advocated as a desirable "aid to small business" measure by J. F. Newcomb, "Tax Revisions for Small Business", *Commercial and Financial Chronicle*, February 6, 1947, pp. 746, 770-771. Newcomb's specific recommendation is to adopt a seven year carry-over period, limiting to $50,000 the amount of taxes paid which may be used for carry-forward purposes.

only upon the permissible period for offsets but upon what complementary steps are taken. Thus, it will be much less assuming allowance of accelerated depreciation and reduction or removal of taxes on low-income brackets than in their absence. There is little doubt, however, that with present rates and rules the innovation would effect a definite cut in yield. One calculation, for example, estimates a reduction of 7 per cent in total taxable earnings with a net national income of $140 billion and a six-year carry-over privilege.*

2. *Rate Graduation*

Progression in the rate pattern has been historically (and still remains) one of the major methods used both to reduce the differential burden on small corporations as against partnerships and to diminish or reverse the discrimination in favor of large concerns to which the present tax system operating within the imperfections of the capital market gives rise. Both the principle of graduation and (assuming its continued acceptance) the most desirable form of graduation are currently subjects of widespread debate.

From a short-run viewpoint, and assuming the desirability of further aid to small business *via* taxation, several arguments may be given for further reliance upon higher progressivity. The mechanics are simple and in line with those already operative. Closer estimates of the effect upon yields are possible than in the case of other measures (e.g., allowance of accelerated depreciation, or the so-called "partnership option"). Such estimates in turn suggest that in all likelihood a substantial further degree of progression would not entail deep cuts in revenue. And recourse thereto seems unlikely to strengthen the obstacles confronting introduction of a more rational business-tax system at a later date.

Critics of graduation rarely discuss the subject of yields, laying emphasis upon anomalous aspects of the device. Apart from the charge that it reflects an illicit transfer to corporations of an "ability-to-pay" argument valid only in the case of individuals, at least three general points seem to be urged:

(a) Progressive rates add seriously to the problem of applying a net income tax fairly to businesses with fluctuating incomes.

(b) Graduation is a crude and in some cases perverse method of dealing with the "small vs. large" problem. Running as it does in terms of absolute money income, it neglects the fact that the same income which in some fields (e.g., steel) may be necessary to give a reasonable yield to small concerns may represent very high income and a high rate of return in fields where even large concerns need only small amounts of capital. For the same reason, it penalizes small firms having large net incomes—and perhaps just at the time when internal reinvestment of the latter is essential to further healthy growth—while giving preferential treatment to large units which show low profits.

(c) Beyond definite limits, steeper progression would doubtless lead to sharp and in part self-defeating changes in the corporate pattern. On the one hand, it might lead many partnerships to incorporate to minimize tax payments. On the other hand, it would provide large corporations with additional strong incentives to splinter for income tax purposes. Both movements would result in reductions of yield larger than those contemplated initially, and the latter would be unlikely to serve any purpose save tax avoidance.

In addition, critics tend to scout the argument that present rates now discriminate against small corporations vis-a-vis partnerships, holding that the possibilities of tax avoidance through payment of large salaries, the escape of undistributed profits from individual income tax, and the high personal income tax rates applicable in relatively low surtax-brackets, combine to render any disadvantage of minor importance. They suggest further that limitation of any net discrimination could be had by permitting the partnership option (see below). The upshot, to quote one well-known tax economist, is that "the argument for graduated rates seems unconvincing. . . . The graduated scale for corporation should [not] be retained unless [no] better means of support for small business from the tax system can be found."**

Without doubt the considerations against progressivity carry a great deal of weight in principle. But in practice the matter is one of degree, not of kind. And on this basis arguments are offered that acceptable results could be achieved without undue difficulty. Given the introduction of a much more extended carry-forward of losses, and thus partial mitigation of the penalty against fluctuating incomes, the basic question is whether a change sufficiently drastic to provide a real stimulus to innovation can be made without reducing yields substantially, opening wide the gates to formal separation of large entities, and aggravating the impact of taxes upon firms with varying positive incomes. In answer, the following considerations seem important:

(1) A number of competent students*** believe that exemption of the first $25,000 of net income, or (alternately) taxing the first $100,000 of income at a rate half that applicable to additional increments would lend encouragement to small enterprise without causing a flood of separations.

(2) Action along these lines would not sacrifice much revenue. To give one example, given the pre-war (1926-1940) corporate income distribution a schedule taxing the first $100,000 of income at 20 per cent and the remainder at 40 per cent would produce between 85 per cent and 90 per cent of the yield resulting from a

* See Groves, *op. cit.*, pp. 388-389.

** Groves, *op. cit.*, p. 89.

*** See, for example, L. A. Seltzer (reviewing Butters and Lintner), *Journal of Political Economy*, October 1946, pp. 459-461; and Musgrave, *op. cit.*, p. 36.

flat 40 per cent tax.* Similarly, exemption of the first $25,000 of income might well relieve most profitable corporations (roughly 87 per cent assuming the same relative distribution by income classes as in 1940, and 83.7 per cent given the 1941 distribution) of all tax burden, while effecting only a slight reduction (13.3 per cent on the 1940 basis, and only 11.4 per cent on that for 1941) in taxable income. Moreover, in the last case replacement of the present rate-scale graduation with a 25 per cent tax on the first $25,000 after exemption, and a 40 per cent tax thereafter would cut yields by only 7.5 per cent and 5.9 per cent on the 1940 and 1941 distribution patterns respectively.

(3) For corporations, it seems probable that by choice of a proper rate-scale it would be possible to reduce substantially, if not eliminate, the inequities said to result from inter-temporal income fluctuations under graduation. In this respect the present pattern is quite perverse, using a several-step progression and concentrating the whole graduation below $50,000—that is to say, in the range over which inter-class movements are likely to affect the largest number of concerns. But introducing progression more sharply and at higher levels—say, in a single jump at $100,000—might well limit discrimination to a relatively small number of cases.

These considerations argue that the questions set forth above may be answered in the affirmative: It is possible to revamp the corporate income tax rate-scale in such a way as to lighten the load on small concerns within the framework of the present tax structure and without large reduction in yields, self-defeating dissolution of large units, or unfavorable effects upon firms with mercurial incomes. That such a remodelling would give a vigorous fillip to investment seems undeniable.

Advocates of differential rate patterns often propose to strengthen investment incentives by way of lower rates or exemptions for all or some part of those retained corporate earnings which are used for business purposes. Such a scheme is advanced sometimes as an alternative to regular graduation, sometimes as a supplementary measure. Of all proposals, it is perhaps the closest to Section 102 in general logic, but would operate the other way, substituting a positive premium for actual investment for a penalty on "unnecessary" accumulation. One variant envisages allowing exemptions subject to the conditions (1) that the privilege apply to not more than 25 per cent of net income, or $25,000, whichever is lower, and (2) that the period of accumulation without use would be held to two years.** In this form, the proposal would be almost exclusively a "small business" measure. Its sponsor recognizes the administrative difficulties which it would confront.

One final point on this general subject. Whatever differences there may be with respect to rate-scale graduation for all enterprises, provision for some such assistance in the case of small new firms has widespread support. Indeed, one leading anti-graduation economist is prepared to exempt *all* reinvested earnings (i.e., to tax only dividends and withdrawals) of such concerns for a period of five years after birth, irrespective of the total amount of income this might involve.*** And among those favoring graduation in general, there is a distinct preference for extra consideration for the "small new" class save in cases where the pattern of general exemptions and rate differentials was already satisfactory. In all cases, the prime object is to stimulate investment by giving new entrants a better chance to establish beachheads in the competitive struggle.

Despite its abstract desirability, this sort of preferential

* This has been shown by Butters and Lintner, *op. cit.*, pp. 133-134, fn2. These authors note that there is a marked tendency for the relative fall in yield to lessen as business activity rises. This conclusion finds support in the experience of 1940-1941, the calculated revenue loss decreasing from 12.1 per cent to 10.9 per cent between these years. In practice, of course, the loss in corporate tax yield would be smaller still, since the change in rates would doubtless lead some partnerships to incorporate. (For this reason, personal income tax yields might decline somewhat, although higher general activity resulting from the lift given to investment would provide a partial offset.)

** See J. F. Newcomb, *op. cit.*, p. 771. In December 1946, the Commerce Department's Small Business Advisory Committee recommended that further study be given to the advisability of granting a small exemption from all federal income taxes for earnings re-invested in the physical assets of the business. Similar sentiments are discernible abroad. At the close of World War II, the highly regarded *London Economist* urged that a premium be put on expenditures for repairs, modernization and plant expansion as opposed to dividends, and suggested as one convenient way to achieve this result a tax on dividends paid in excess of either the current or the pre-war rate. Admittedly, the scarcity of both consumption and capital goods is greater in England than here; the only point is that it is still not as great as the difference in British and American policies.

The practices of other capitalistic societies seem to be both more severe and less severe than our own. In the United Kingdom, to take one example, where private companies under the control of not more than five persons fail to distribute a reasonable portion of their earnings, a super-tax corresponding to the additional tax that would be paid by each stockholder in case of complete distribution of the corporation's profits is assessed on the stockholder. If the latter does not pay this assessment, it lies against the company. In Australia a similar procedure applies to "private companies" under control of not more than seven persons, and the tax is assessed directly against the companies. "Reasonable distribution" is determined by special commissioners in England, whereas the Australian statute requires distribution of all dividends received from other private companies plus two-thirds of other distributable income. (See *The Postwar Corporation Income Tax*, U. S. Treasury Department, 1946, pp. 35-36.) However, limited companies in England are allowed a 20 per cent post-war refund on their excess profits which the government reputedly does *not* wish to be diverted to stockholders. Before the war at least the earnings of Dutch corporations were taxed if distributed and exempted if retained. France, Chile and Belgium taxes both disbursed and retained earnings. (Belgium bore down heavily on retentions.) After taxing retentions for some time, Sweden abandoned the practice insofar as general business was concerned. And countries which had the device throughout pre-war days (Norway, and reputedly some Swiss cantons, for example) usually kept it at low levels and /or granted corresponding deductions from taxable incomes and a refund of the penalty upon subsequent disbursement. In addition, there are several instances of preferential treatment for reinvestments. Perhaps the outstanding case is that of Sweden, which since 1938 has given firms permission to set aside part of their profits in special tax-free funds on condition that they will spend same on buildings and construction during a period thought by the government to be suitable—presumably a period of depression. Denmark, too, gave tax credits on earnings reserved for certain designated purposes.

*** H. M. Groves. See his *Postwar Taxation and Economic Progress*, (New York, 1945), pp. 103-104.

treatment raises serious problems on points of administration. Ideally, the enterprise should involve the innovation of products or processes, or at any rate new entry into a going industry; the firm should not (initially) have assets exceeding, say, half a million dollars, or close financial ties (especially corporate stockholders) with existing businesses, whether incorporated or unincorporated; and its establishment should entail the acquisition of new capital assets, or diversion of existing facilities to new uses. But rigorous adherence to all these criteria doubtless would exclude a large number of deserving prospects. "Each case should be judged on its merits", as in the fashion of 102 Administrators, and it seems doubtful whether a simple and generally acceptable way can be found for so doing. That one student* has been led to suggest establishment of a special tax court to determine eligibility attests to the difficulties. In any event, it has been strongly argued that the adverse direct effect upon corporate tax yields would be much less, and the fillip given to investment per dollar reduction in revenue much greater, with any small new business exemption than in the case of generalized changes in rate progression.

3. *The Partnership Option*

Of proposals designed to help small corporations *per se,* that made most frequently has been to permit concerns below a certain size (measured in terms of assets) to regard themselves as partnerships for purposes of corporate income taxation. Simply by exercising the option, the managers and stockholders of such firms could escape the corporate income tax on dividends and retained earnings and be able to offset losses against personal income if this would reduce the total tax burden. On the other hand, it would be permissible to choose the corporate form and retain earnings in order to conserve resources when stockholders are already (or by choosing the partnership method would place themselves) in high surtax brackets. The advantages resulting from the option would accrue exclusively to small units, in contrast to exemptions or reduced low bracket rates which would benefit all corporate entities to some extent. The option would not affect significantly the operation of Section 102. Any small, closely-held holding or operating corporation which chose to accumulate surplus "improperly" in face of the "102" penalty rates would still find this course advisable (i.e., would elect to be taxed as a corporation) under the option, and conversely.

It may be useful to distinguish the "option" approach from more general proposals with respect to the partnership-corporation problem. Agreement is general that in principle the only way to effect complete integration of corporate and personal income taxes (and thus to eliminate fully the "double" taxation of dividends) is to tax stockholders currently at the appropriate personal income tax rates on both distributed and retained profits, and to impute thereto corporate losses on the same basis. But it is just as widely recognized that this method poses such vast administrative difficulties and could react upon stockholders so unfavorably as to render its full-scale institution infeasible.** For large corporations, it would be necessary to deal with hundreds of thousands of stockholders. In such cases, too, the individual stockholder has little control over dividend policy, and might be hard-pressed to meet tax payments if dividends were not paid. Moreover, when several classes of stock are outstanding the allocation of earnings through time would present immense difficulties. A problem would arise in connection with shares not held throughout the taxable year. And finally, it might be necessary to re-open and amend each stockholder's return in a given year whenever audit, court decision or carry-backs led to a significant change in taxable corporate net income for that period. On the whole, it seems very doubtful whether the compulsory partnership method is applicable save in the case of small units with a few classes of stock. Limiting the method to such corporations, and in addition rendering its use voluntary, as does the "partnership option" proposal, avoids most of these difficulties.

The degree of benefit conferred by a partnership option for small firms would depend largely upon whether it was alternative or supplemental to exemptions, further changes in the rate structure, and liberalization of loss carry-forwards. Given substantial adjustment in these areas, its effect upon yields (always adverse if the option may be exercised anew each year) and activity may be small. Save in the limiting case, however, it should operate to reduce inequities and encourage investment.

4. *Accelerated Depreciation*

Proposals to stimulate investment by permitting businesses to reduce the time-period over which replacement costs may be written off against taxable net income find favor with many students. In principle, granting of this privilege would not discriminate among corporations with respect to size, but relatively speaking the prime beneficiaries would be small, *expanding* firms. As matters now stand, depreciation and obsolescence allowances for large corporations are quite liberal whereas the young, growing enterprise with heavy *prospective* investment outlays relative to charges against existing assets is in a much less enviable position.

A major problem with respect to acceleration concerns the areas it would cover. Full realization of the advantages for small firms would require permission to apply it to existing assets, thus swelling temporarily the pool of investible funds at their disposal. But to give the same right to large corporations might lead to a sharp absolute growth in corporate hoarding and consequent diminution in the additional direct investment per dollar

* Musgrave, *op. cit.,* p. 37.

** See, for example, J. L. Connally, "Proposed Remedies for Defects in Corporate Taxation," *Commercial and Financial Chronicle,* December 12, 1946, p. 3024. A very useful and compact summary of the whole problem may be found in *The Postwar Corporation Tax Structure* (U. S. Treasury Department, 1946), pp. 27-32.

reduction in tax yield. Similarly, for large corporations the marginal stimulus to new investment is likely to fall off markedly as the permissible degree of acceleration in rates rises. Assuming use of the same pattern for all concerns, therefore, these considerations would seem to dictate confining the concession to newly acquired depreciable assets (or some fraction thereof) and setting a reasonable upper limit to its degree.* Alternately, it would be possible to confine acceleration for large corporations to new assets and moderate rates while offering small concerns much more liberal treatment. As in the case of graduation, the problem here would be so to define class boundaries as to minimize formal separation for tax purposes.

Unless the corporate tax pattern remains stable, any of the variants just set forth would raise problems assuming allowance of wide latitude in allocating charges over time and the absence of adequate loss-offsets or income averaging devices. The reason is that businesses would tend to concentrate write-offs in years of high rates. Furthermore, even with a stable rate structure, the device might have perverse cyclical effects, tending to induce large charges and thus to give a strong stimulus to further investment and consumption when incomes, employment and (with graduation) effective tax rates are high and checks upon spending may be desirable. Both difficulties would remain, albeit in less acute form, under a strictly proportional income tax. The first would (and the second might) be avoided by requiring firms to select a schedule at the outset and adhere thereto throughout the life of the assets to which it relates.

The effect of acceleration on tax yields is difficult to determine not only with respect to general magnitude but with respect to duration. Taking magnitudes first, it is evident that, assuming the present tax pattern to remain unchanged in all other respects, the revenue reduction would be largest for those plans covering all assets (both new and existing) and all corporations, smallest where only new investment of small corporations received preferential treatment. On the other hand, any given plan will affect revenue less markedly the lower is the general level of corporate tax rates and the more moderate their graduation. Under almost any method and in most circumstances, the net fall in yield will be less than the direct reduction since the resulting additional investment will generate higher corporate and general incomes. On the side of duration, the direct annual loss in yield will cease when the new schedules have been in effect sufficiently long to set replacement needs on the "accelerated" basis. The length of this process will depend upon the volume of additional investment to which the acceleration gives rise.

If there is opposition to extending more liberal depreciation privileges to such broad categories as "large" or "small" corporations, it would still be possible to grant these in the case of small new firms. The degree of benefit, of course, would depend upon the character of exemptions and rate-scale graduation; but so long as the privilege could reduce the amount of income which would otherwise incur taxes in early years, it could prove advantageous to these concerns.

5. *Research and Development Expenditures*

Among the more perverse elements in our present corporate tax policy is its treatment of "intangible expenses", or at any rate their major component, viz., expenditures for research and development. On general considerations it would seem advisable to lend utmost encouragement to the latter since no other sort of endeavor is likely to yield as high returns per dollar spent. Yet, as a result of recent Bureau of Internal Revenue policy businesses find themselves increasingly unable to put research costs on a deductible basis, but must rather capitalize such investment and hope to establish a period of useful life over which to schedule its amortization. The effect is to place a very heavy burden on forward-looking research and thus to retard the prospective rate of innovation.

From what has been said it will be evident that, in principle, the problem of more liberal allowances in this sphere is a special case under the general problem of accelerated depreciation. The difference of degree, however, is so great as to constitute almost a difference in kind. In the first place, due to the very nature of research expenditures the case for complete freedom in their allocation is much stronger than that with respect to ordinary capital assets. In addition, the dividing-line between research outlays and more routine capital expenditures for physical plant is in most instances sufficiently clear to render special treatment feasible even if the decision should be against acceleration in general. And finally, most small, expanding companies would benefit much more (per dollar reduction in tax) from relief in this connection than from generally liberalized depreciation allowances. Both the possibility and desirability of special consideration are already recognized in England and Canada, which for some time have had affirmative statutes permitting current deductibility of research expenditures, and in 1944 enacted legislation to allow accelerated depreciation rates for the capital facilities of research; and there is a rare unanimity of opinion among American students that such favorable treatment should be accorded over here, either administratively or through legislation.

It is impossible to estimate closely the effect of special exemption in placing all research expenditures on a cash basis. It seems clear, however, that the net loss would be insignificant. Even with vastly expanded research work, it appears doubtful whether outlays for this purpose, however broadly defined, would reach high levels in the calculable future. [Expenditures in 1940 seem to have been around $300,000,000.]

* One suggestion is to permit acceleration only on the first $10,000 or $15,000 of assets bought in any one year, and limit it to the first 35 per cent to 50 per cent of the cost of such assets, requiring the remainder to be written off over the latter's normal life. See Newcomb, *op. cit.* p. 771.

III. CONCLUDING REMARKS

There are grounds for suspecting that Section 102 is not much shucks of a tax. It is necessary, but even so may be useful principally in illustrating the life of a patch in a jerry-built tax system. The Congress set out reasonably enough to stop the avoidance of surtaxes. Its method of doing so turned into an economic judgment on the best disposal of corporate surpluses. The effect does not show merely because of other inadvertencies which in the main confine the penalty to small business. The tip-off is really in the administrative standard that must be used—"unreasonable accumulation". Under ordinary circumstances "reasonableness" can probably be "determined" by reference to standard practices without too much injustice. After an epic of construction and destruction such as the world has just enacted, no one knows what the future holds. Reading the prophets is merely discouraging exercise. Will business volume induce a great wave of plant expansion or will it not? Where will wages, other costs, prices, and short and long-term incentives finally come into even tentative equilibrium? Will prices match current costs of replacement? Will basic adjustment be impossible without the purge of a post-war depression? What will be the relative importance, over the next few years, of consumption and investment functions? Business does not know the answers to these questions, neither does the Bureau of Internal Revenue.

Unfortunately, the problem can hardly be solved by tinkering with Section 102 itself. In its distress business might ask the Bureau of Internal Revenue to resolve all economic doubts against itself for a while as it did during the war. A little extra tolerance would indeed seem to be called for in this formative period, although basically the Bureau can answer "for how long, when are you likely to admit that the economic outlook is clear, and how are we going to explain our seeming inaction to the Congress?"

The answer lies, therefore, outside of "102" and in the tax system that required it. Clearing that wilderness is going to take a long time, and indeed it may be reasonably questioned whether this is even the right time to start, except for planning and debate. Both the public debt and inflationary pressures are still high. Their translation into tax language is that the reductions and the sorts of stimuli that are likely to accompany major tax reforms might better wait. However, there are many grave differences of opinion on substance to be settled before timing need bother us. At least there is a logical direction in which to move if the point of departure is Section 102. Small operating corporations are accidentally its principal victim because an intention to avoid personal surtaxes can be more readily proved against closely held concerns. The mental sequence to which this discovery gives rise might run as follows:

Success is more than proportionally difficult for small—especially small new—business, whereas both our sympathies and the public interest would have it otherwise if the cost of reversal is not too high. At least our tax system should not discriminate against such concerns, and in view of the improbability of approximating tax justice, the scales might even be tipped slightly in their favor without infidelity to democratic principles. Today, at best, the weights barely balance and may be adverse. The method of treating losses prescribed by present laws are especially distressing to small businesses, exposed as they characteristically are to wide cyclical swings, and vulnerable as they are to the risks of innovation. Because of the customs and costs of the money market they must earn their own new capital, but are frequently taxed on it at rates not much lower than those applying to concerns able to borrow at will. Moreover, the new capital may be taxed again and even more heavily if an immediate tangible use for it cannot be clearly proven—a danger which their larger competitors need seldom fear. Tax rates are graduated for small corporations, to be sure, but in a manner that may force the rewards of an *extra* effort into tax brackets far above those occupied by the larger and more secure. Tax treatment of depreciation and research costs as routine rather than dynamic investments is hard on most companies but particularly so on those that are small and growing. A small man may feel that taxes are tracking him down, whereas in fact they are merely clumsy and poor at making fine distinctions in a complex economy.

The literature is full of tax proposals to help the small corporation. After sifting, they seem to fall into three rough classes as to principle:

1. The small corporation's total tax might be reduced by an improved pattern of graduation. "102" would still be lying in wait, but to the extent that it was not made inapplicable by a showing of need the penalty might still not offset the advantage of the change in schedules. Progression cannot clearly be urged on the principle of "ability to pay", despite the political fascination of that argument, for the reason that differently situated owners stand behind each corporation. It still has defenders, however, as a means of compensating, even if crudely, for the disproportional hazards (both tax and non-tax) of small corporations.

One suggested form of graduation would include outright exemption of a portion of corporate income, or of some fixed sum. The specified amount would automatically be protected from Section 102—the only form of a flat and universal exemption from the "unreasonable accumulation" penalty that can be easily defended. To exempt a retention found to be "unreasonable" from a tax on "unreasonable" retentions, except as the incidental result of a larger purpose, would hardly be rational. Or, in greater harmony with the philosophy of Section 102 but with reversed emphasis, re-invested earnings might be exempted in whole or in part from any income tax.

2. The volume of receipts in any given year to be considered as income might be reduced through more flexible depreciation and development allowances, or through the carry-back or carry-forward of losses, or some variant of the latter that would insure complete allowance for losses over as short a time period as possible.

3. Allowance of a "partnership option", i.e., permitting the owners to choose, to their own advantage, whether to be taxed as individuals or as a corporation. In this method, where a choice is feasible, lies the greatest flexibility. Where the choice is to be taxed as a corporation, the hazards of Section 102 would still have to be faced.

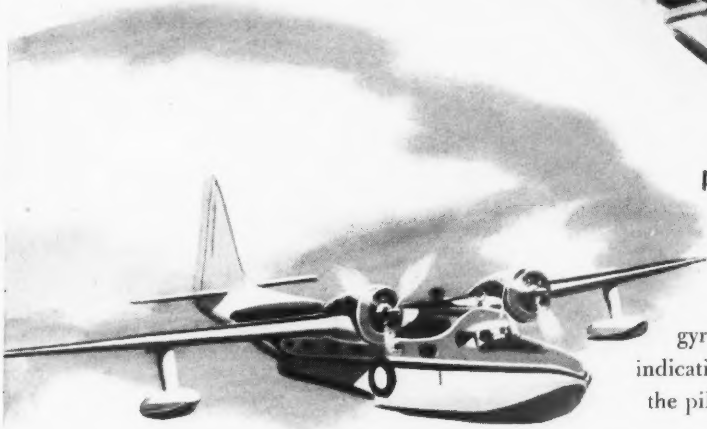
The major criteria against which any one (or any combination) of these measures must be set in deciding upon their wisdom at this juncture—viz., equity, implications for investment, effect upon yields, consistency with a long-term program of tax reform—have been set forth earlier and do not need elaborate restatement at this point. A few summary comments, however, are appropriate. The experts seem to be largely agreed on a more liberalized treatment of business losses, which would help all businesses but particularly the small. Optional reporting is highly regarded. The problem of depreciation and research costs is not so frequently discussed, but many are convinced that even without discrimination more flexible schemes could be devised to cope with a serious and peculiar handicap of rapidly growing concerns; some would discriminate deliberately in their favor. Graduation in rate structures is very controversial, with many tax students and counsellors of high standing arrayed on opposite sides of the argument. Apart from matters of principle, the issue is one of devising a plan that will carry help to those deserving it without inducing large-scale avoidance through splintering or raising new impediments to risk-taking at the breaking points.

The problem of keeping a sense of proportion in this discussion has been evident. To start with Section 102 in overhauling our mammoth tax system suggests a B-29 trying to take off from a postage stamp. But the irritation is real and widespread, especially so in a transitional period when men face enough uncertainty without swapping gargantuan guesses with the Treasury on the country's future. The discussion of correctives has been limited therefore to that part of our over-all tax problem that (a) is aggravated by Section 102, and (b) might be undertaken now without making new difficulties for the bigger job to come. On the first count some of the unfavorable effects of our general tax rules on small corporations clearly qualified, and on the second the feasibility of interim relief seemed to be at least arguable.

The present authors are not insisting that this second test is met, much less urging the adoption of any specific set of changes. At least when free of the embarrassment of an imminent test, many economists and executives have felt that—if we meant business—there is still need to guard against inflation and there could hardly be better circumstances than the present for reducing the public debt. The burdens are disagreeable, as they always must be, but both objectives entail going long on tax maintenance and short on competitive bidding for those goods which are still in meager supply. Should this thesis still be accepted, the time is hardly more propitious for tax relief for small business than for most other people. One crucial point merits emphasis, however. Timing is not the core of the Section 102 argument. The core is that a piece of our tax laws is signalling some of the chaos that lies within, that one of the ways to expedite remedial action is to advertise the disorder, and that in this instance it seems possible to alleviate the difficulties in various ways without undermining major objectives. Whether or not general short-term tax policy should be kept anti-inflationary, there is sound reason for the Congress to give serious consideration to a small corporation tax relief program. It is believed that the proposals discussed above are sufficiently seasoned for transfer to the legislative arena.

The Sperry A-12 Gyropilot on executive planes . .

As the human pilot's automatic "co-pilot" on one-man operated executive aircraft such as the Grumman-Mallard, the Sperry A-12 Gyropilot eases the strain and fatigue of long flights . . . facilitates flying accurately by dead reckoning when busy executives must fly off the regular airways to visit out-of-the-way plants.



provides smoother flight with less pilot effort and greater safety

With the Sperry A-12 Gyropilot and Gyrosyn Compass supplying complete gyro-stabilized control and accurate directional indications under all flight conditions . . . the pilot can do his job better and with less effort than by manual control.

and with greater comfort and relaxation for executives

Passengers land completely relaxed and refreshed from the smooth ride made possible by the A-12 Gyropilot. Its precise automatic control eliminates over-control, "hunting" and "wallowing," holds the aircraft level and comfortable regardless of air turbulence.

. . .

AND IN THE MARINE FIELD, Sperry Gyro-Pilots, linked with Sperry Gyro-Compasses, are providing automatic straight line steering.

Sperry Gyroscope Company, Inc.

SPERRY

EXECUTIVE OFFICES: GREAT NECK, NEW YORK • DIVISION OF THE SPERRY CORPORATION

NEW YORK • CLEVELAND • NEW ORLEANS • LOS ANGELES • SAN FRANCISCO • SEATTLE